A7000-1

REAL ESTATE

Vol. 3, No. 11

November 1990

OUTLOOK

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The economy grew a surprisingly strong 1.8 percent in the third quarter, according the government's preliminary estimates. While the rate is less than half the of the average annual rate during the 1982-89 expansion, many analysts had expected a figure much lower -- perhaps even negative. The GNP report, however, may be misleading, and other indicators strongly suggest that the economy is running on a recessionary track.
- The current NAR forecast calls for a mild recession beginning in the fourth quarter of 1990, with a modest recovery begining by the third quarter of 1991. The economy is expected to record a 1.1 percent growth rate for 1990 and gain 0.4 percent in 1991. With a recovery well under way, the economy will expand 3.0 percent during 1992. These rates compare to a 3.9 percent average for economic growth between 1982 and 1989.
- The housing slump continued in September, as housing starts fell for the fourteenth time in the past twenty months. The annual rate for August was 1,135,000 units, the lowest level since the end of the last recession in October 1982. The figure, however, was higher than the orignal estimate of August housing starts, which was revised up by 15,000 units to 1,142,000 units. Housing starts were about 10 percent below their pace of a year ago, and are expected to reach bottom in the current quarter.
- ~~The rate of~~ new homes sold declined a sharp 6.0 percent in September, and revised figures for previous months show a weaker market than had orginally been thought. The sales rate for the third quarter dropped 2.2 percent below the second quarter's pace. All four regions of the country experienced declines in September.
- After posting a sizeable gain in August, the annual sales rate for existing homes dropped by 8 percent in September to 3,220,000 units, the lowest level since January 1988. Although the third quarter's sales rate bested the second quarter's by 1 percent, the September figure, coupled with uneasiness over the direction of the economy, lead the NAR forecast to call for further declines in the sales rate. The low point is expected to come during the second quarter of 1991.

IN THIS ISSUE

- **In the Land of the Lotus-Eaters**
  -- Economic Commentary, by John A. Tuccillo
- **Outlook for the Economy and Real Estate**
  -- by Robert D. Barr
- **Bubble Bathos**
  -- by Donald R. Leavens
- **Table: Existing Home Sales**

NATIONAL ASSOCIATION OF REALTORS®

REALTOR®

The Voice for Real Estate™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW   Washington, D.C. 20005

Copyright 1990 NATIONAL ASSOCIATION OF REALTORS®

In The Land of the Lotus-Eaters

by
John A. Tuccillo
Chief Economist
and Senior Vice President
Real Estate Finance

On his ten-year journey from Troy (Anatolia, not New York) back to Ithaca (Greece, not New York) and his beloved Penelope, Odysseus and his crew faced many and varied dangers. Perhaps the most seductive of these lay in the land of the Lotus-Eaters, a tribe who consumed a diet (of lotus leaves, not spreadsheet software) designed to induce pleasure and amnesia and who tempted all visitors with a similar prospect.

In many ways, the United States economy has, for the past decade or so, been much like the land of the Lotus-Eaters. We have enjoyed a deceptive sense of prosperity and forgotten about the real business of building a sound economy. Regardless of the prospects for recession--or at least unacceptably slow growth--over the next six to twelve months, we have indulged a false sense of optimism and may well have left ourselves poorer for the future.

Prior to the oil shock of 1973, the American economy had experienced real growth of epic proportions. Labor productivity, largely the result of a growing capital stock, increased at an average annual rate of 3.5 percent, well above the historical trend of 2.5 percent that had prevailed earlier in the century. Since prosperity in a modern industrial society is critically linked to growth and productivity, these were, indeed, golden years. The average forty-year old male worker in 1953 could look forward to a 54 percent increase in real income by the time he was fifty, largely because of increasing productivity.

After 1973, the world became a different place. As foreign economies developed, markets which had previously been exclusively American were now open to intense competition. With the collapse of the international monetary system and the abandonment of gold, the pressures on the dollar as a reserve currency became intense. The result was a built-in bias toward inflation in the domestic economy (intensified by the oil shocks of 1973 and 1979), a retrenchment of American industry and a sharp decline in productivity. From 1973 through the end of the decade, productivity increases averaged 0.9 percent. The average male worker who was forty years old in 1973 had suffered a *decline* of 14 percent in real income by 1983.

But, with the exception of the contraction of 1980-82, the years since 1973 have been generally ones of growth and relative prosperity. How has this been accomplished? Enter the lotus. The reality of the American economy has been masked by social demographic and political changes.

Socially, the number of childless, two-earner households increased rapidly as more women entered the labor force and postponed childbearing. This meant that the percentage of income available for consumption increased over the decade, fueling expansion. The household with no mortgage or child-rearing expenses could more readily consume. As a consequence, the savings rate was driven down to historic lows. Currently, more than two-thirds of all married couples rely on two incomes, leaving little room for continued expansion. There simply are no third incomes on the horizon.

Demographically, the "post-war" generation has come into its maturity during this decade. Thus, more workers produced, earned and consumed than in the past. This has created the delusion of "better," when the reality is simply "more." Succeeding generations will not be nearly as large as this one and there will be a slump in demand as fewer individuals pass through prime consumption years.

Politically, we have made a national decision to borrow from others and have chosen the rest of the world as our benefactor. Foreign capital flows have become the stuff of legend to the point where no cocktail party worth the name is complete without some reference to our national dependence on foreign funds. We have in fact maintained our prosperity by living beyond our means, with the full acquiescence of our "friends." (Perhaps we need to form a "Mothers Against Foreign Borrowing" and take away the government's credit rating when it's had too much.)

But our partners will only lend to us as long as we keep our real interest rates high relative to the rest of the world. As high real rates mean that investment becomes expensive, capital growth staggers, and productivity growth remains low. And like the Lotus-Eater looking for the next bush, we need foreign funds. We can't at this point lower our rates and discourage the inflow.

So, how do we get out of this dilemma? How do we change our diet? The solutions are obvious, but not easy. We first of all have to break our dependence on the international markets, so that we can direct economic policy to domestic goals. This means making a continuing real effort to eliminate the federal budget deficit. The recent budget agreement is a start, but only that. What looks like $500 billion saved may well be much less as less than brilliant economic performance robs us of promised out-year savings. More fiscal restraint must come in the future.

Second, we need to postpone consumption and tilt the balance of economic activity toward savings and investment, so that we can become a productive competitor in world markets. This means increasing taxes on consumption activities and using selected preferences to encourage savings. Both these measures require real sacrifice on the part of the American public, but are absolutely crucial to the construction of a firm base for real future prosperity.

Ultimately, Odysseus broke the spell of the Lotus-Eaters, led his crew away from their island and finally reached Ithaca. It's time to take a clear look at this economy through eyes fixed on real values and turn away from the temptation of the now.

Outlook for the Economy and Real Estate

Just as most observers were declaring that a recession was either underway or imminent, the government released data showing surprising strength in economic growth. While the 1.8 percent annual rate of GNP growth is less than half of the average growth rate during the 1982-89 expansion, many analysts had expected a figure much lower -- perhaps even negative. Yet the observers were not wrong: The economy *is* running on a recessionary track.

The GNP report could be misleading for a couple of reasons. First, the quarterly figures disguise a more moderate monthly pattern of consumer spending, which will be discussed below. Second, the numbers are based upon incomplete data and are consequently biased toward economic activity in July and August rather than in September. Revisions will be released twice before year end, and most analysts suspect that the 1.8 percent rate will be brought down. The second-quarter growth rate, for example, was initially estimated at 1.2 percent but has since been revised down to 0.4 percent.

A mild recession remains in the NAR forecast. The downturn is expected to begin in the current quarter, but the subsequent recovery is anticipated to begin by the second quarter of 1991. Year over year, economic growth is projected at 0.4 percent in 1991 and 3.0 percent in 1992.

Worried Consumers Spend More . . . Or Do They?

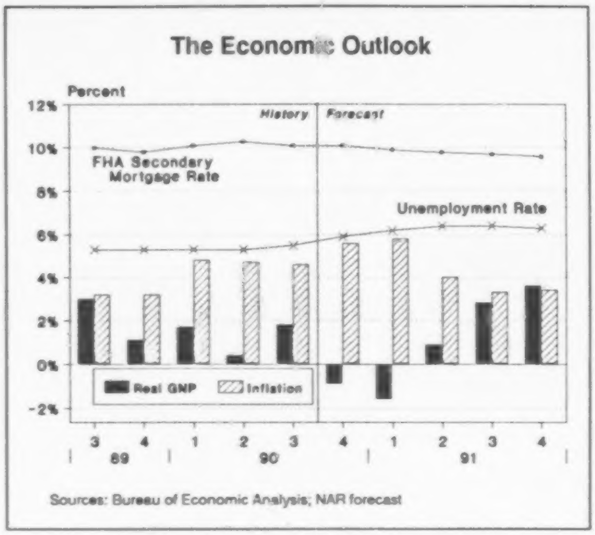
At first glance, it appears that consumers are relieving their anxiety over the Persian Gulf standoff, higher taxes, and a possible recession by heading to the mall. Despite October's plunge in consumer confidence -- the largest drop ever captured by the Conference Board -- consumer spending in the third quarter rose $23.9 billion over the second quarter. The increase during the second quarter was only $1.5 billion. One important source of strength was spending on autos, which sold at their fastest pace in a year during September.

Yet the quarterly figures hide an inauspicious monthly pattern of consumer spending. A huge burst of spending in June gave the third-quarter figures a high starting point. Even with moderate increases in July and September and a small decline in August, the third-quarter average stood much higher than the second-quarter average. Consequently, the growth rate between the two quarters appears to reflect strong spending growth in the third quarter.

The flip side -- since these statistical quirks even out over time -- is that even moderate monthly increases in October, November and December could lead to a decline in the fourth-quarter growth rate, since it will be calculated against the relatively high third-quarter figure. In other words, consumer spending will have to be quite robust in the final quarter to avoid a negative growth rate.

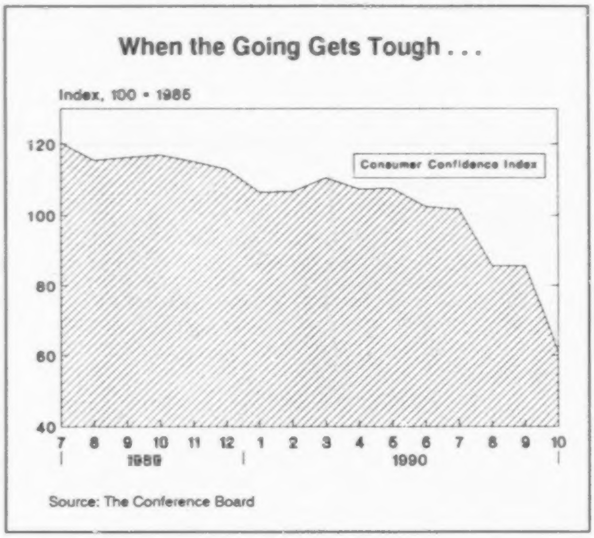
Consumers to Cut Back Over the Next Few Months

Two factors may lead to cutbacks in consumer spending over the next several months. First, disposable income, after adjustment for inflation, fell at a 4.9 percent annual rate in August and September, which suggests limited spending ahead. Second, data for September imply that consumers used their savings to maintain spending. In the months ahead consumers are likely to trim spending to restore their savings balances.



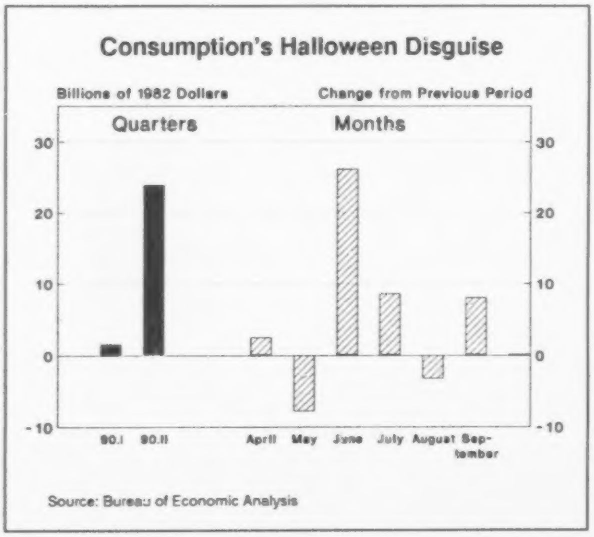
The Economic Outlook

Sources: Bureau of Economic Analysis; NAR forecast



When the Going Gets Tough . . .

Source: The Conference Board



Consumption's Halloween Disguise

Source: Bureau of Economic Analysis

Why a Recession Still Looks Imminent

With consumer spending expected to cool, will some other component be able to pick up the slack? Seemingly not, as many other factors point to weakness. For example, the government's index of leading indicators followed August's steep 1.2 percent drop with another 0.8 percent decline in September, when only one of the index's eleven components, business investment contracts, was higher over the previous month. Also in September, the value of new construction fell for the sixth consecutive month, leaving it declining at a 13 percent annual rate over the period.

Meanwhile, a survey of the nation's manufacturing firms shows that orders for durable goods fell by 1.4 percent in September. The value of new orders for all manufactured goods rose only 0.1 percent, but even that figure overstates the health of manufacturing since it reflects the impact of higher oil prices on petroleum products, not higher overall volume. In addition, the widely watched index computed by the National Association of Purchasing Management fell to 43.4 percent in October, its lowest level since late 1982.

The unemployment rate has crept up about a half point since June and stands at 5.7 percent. Total employment fell by 68,000 workers in October, with manufacturing accounting for 61,000 of those jobs. Since March 1989, manufacturing payrolls have been slashed by 486,000 jobs.

Exports, a significant contributor to the expansion over the past few years, remain the most promising area for growth. Although it will take time for its effects to work through, the lower dollar will allow U.S. firms to price their products more aggressively overseas.

The Dollar Continues to Fall -- What's A Fed to Do?

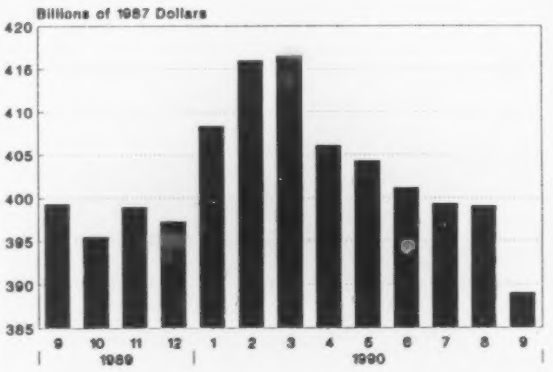
During October, while Washington wrangled with the budget and recession edged nearer, the U.S. dollar fe[illegible] record lows. Even the Persian Gulf crisis has [illegible] stengthened the dollar, as increased international ten[illegible] usually does. The dollar's decline reflects relatively low U.S. interest rates. The higher rates in Europe and Asia are attracting the international capital that until recently flowed to the U.S. If the dollar continues falling, interest rates will have to rise -- or at least be higher than they otherwise would have been -- to satisfy the need for credit in the U.S.

This has important implications for the Federal Reserve. Responding to the budget agreement, the Fed cut the key short-term federal funds rate by a quarter of a point -- not enough for some on Capitol Hill. The case for easing monetary policy further is anything but clear cut: Too much ease will send the dollar down further and increase anxiety over inflation, even as it runs at a 10 percent pace. That means higher long-term rates. Too little ease means that short-term interest rates stay up, possibly pushing the economy further into recession.

Two Important Risks

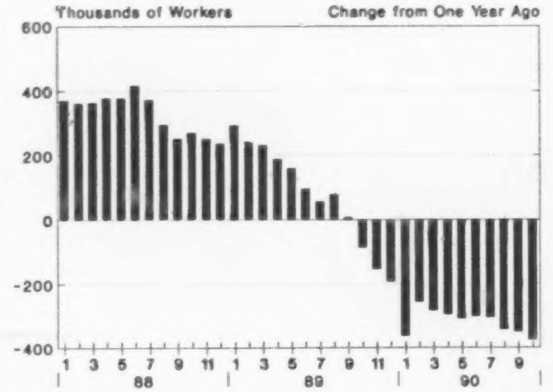
As projected, the recession is milder than the typical post-World War II downturn. A deeper and more severe recession would be the likely result of either a war in the Persian Gulf or the continued unraveling of the financial condition of major U.S. depository institutions.

Construction Expenditures Slow



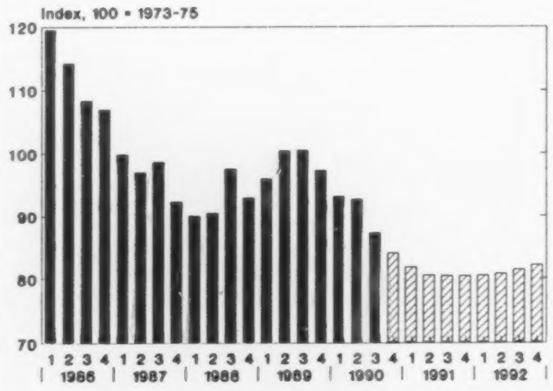
Source: Laurence H. Meyer & Associates

Manufacturing Payrolls



Source: Bureau of Labor Statistics

The Dollar Continues Its Fall



Sources: Federal Reserve Board, NAR forecast

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

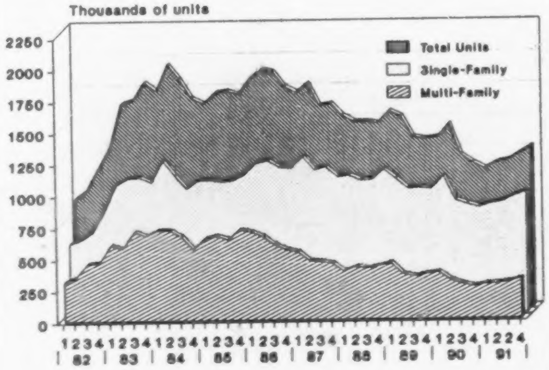
	Total	SF	2-4	5+
Sep 1989	1,263	969	56	238
May 1990	1,206	897	36	273
Jun 1990	1,189	889	42	258
Jul 1990	1,153	875	29	249
Aug 1990	1,142	841	31	270
Sep 1990	***1,135***	***877***	***36***	***222***
Annual Averages:				
1988	1,491	1,086	59	347
1989	1,386	1,010	55	321
Percent Changes in September 1990 since:				
Sep 1989	-10.1	-9.5	-35.7	-6.7
Aug 1990	-0.6	4.3	16.1	-17.8

Regional Data

	Northeast	Midwest	South	West
Sep 1989	160	247	486	370
May 1990	127	256	487	336
Jun 1990	113	241	535	300
Jul 1990	113	225	493	322
Aug 1990	118	241	440	343
Sep 1990	***105***	***249***	***453***	***328***
Annual Averages:				
1988	240	273	574	404
1989	183	270	536	397
Percent Changes in September 1990 since:				
Sep 1989	-34.4	0.8	-6.8	-11.4
Aug 1990	-11.0	3.3	3.0	-4.4

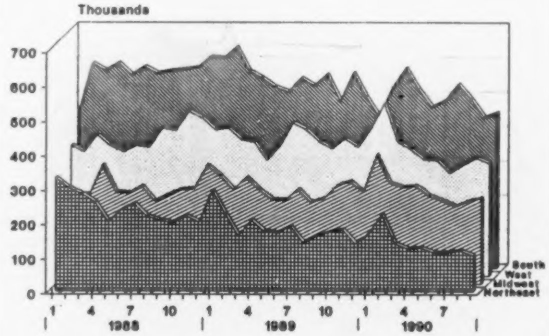
Source: Bureau of Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of Census

For the eighth consecutive month, housing starts fell in September to an annual rate of 1,135,000 units -- the lowest rate since the end of the last recession in October 1982. September also marks the fourteenth month in the past twenty that the rate of starts has fallen.

Given the growing perception that a recession is imminent, along with the threats of war, significantly higher inflation, and budget-related government paralysis, the 7,000-unit decline from August's pace was relatively mild. The decline was only 0.6 percent, much less severe than the average 4.4 percent decline in the previous seven months. Starts during the the third quarter ran at a 1,143,000-unit pace, down 5.3 percent from the second quarter's rate.

Housing starts are projected to reach bottom in the fourth quarter of 1990 at a 1,095,000 annual rate. Slightly lower interest rates, largely a result of the slumping economy, should give a modest boost to housing starts during 1991. By the fourth quarter of 1991, starts should be at a 1,271,000-unit pace, and economic recovery is expected to spur starts to 1,298,000 units in 1992.

Behind the national decline of 9 percent on a year-to-date basis, the regional performances in 1990 have been widely divergent. The slump is concentrated in the Northeast, where starts are down 28 percent in 1990's first nine months. Both the South and the West are down by about 9 percent. For the Midwest, meanwhile, 1990 has seen a 2 percent improvement so far.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

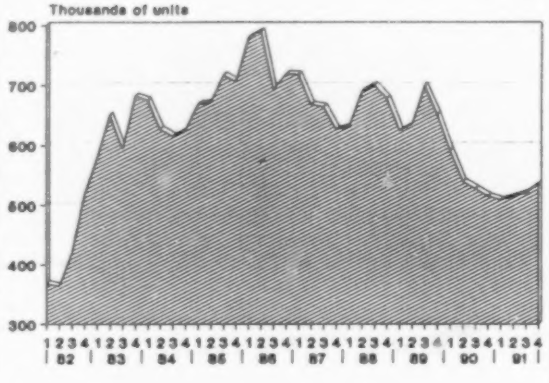
		Mo. Ago % Chg.	Yr. Ago % Chg.
Sep 1989	638	-11.3	-7.7
Oct 1989	636	-0.3	-11.4
Nov 1989	637	8.0	5.7
Dec 1989	633	-7.9	-5.4
Jan 1990	613	-3.2	-12.9
Feb 1990	606	-1.1	-2.7
Mar 1990	558	-7.9	0.4
Apr 1990	533	-4.5	-12.6
May 1990	536	0.6	-17.7
Jun 1990	550	2.6	-14.9
Jul 1990	545	-0.9	-26.5
Aug 1990	535	-1.8	-25.6
Sep 1990	***503***	***-6.0***	***-21.2***
Annual Averages:			
1988	676		0.8
1989	654		-3.3

Regional Data

	Northeast	Midwest	South	West
Sep 1989	62	102	260	214
Mar 1990	84	94	221	159
Apr 1990	86	90	209	148
May 1990	71	91	215	159
Jun 1990	80	94	233	143
Jul 1990	71	94	242	138
Aug 1990	64	93	242	137
Sep 1990	***54***	***91***	***223***	***136***
Annual Averages:				
1988	101	98	271	206
1989	90	103	258	202
Percent Changes in September 1990 since:				
Sep 1989	-12.9	-10.8	-14.2	-36.4
Aug 1990	-15.6	-2.2	-7.9	-0.7

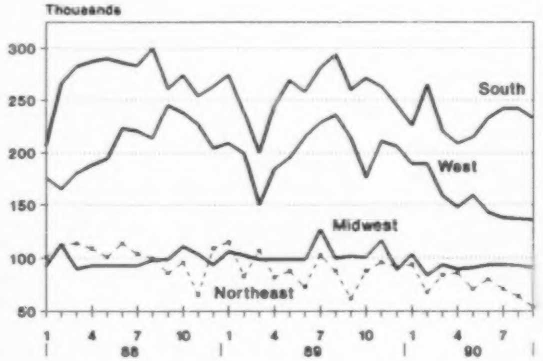
Source: Bureau of Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of Census

The most recent report on new home sales shows a housing market weaker than had been previously thought. First, the report provided the initial estimate of the rate of new homes sold in September: 503,000 units, down 32,000 units, or 6 percent, from August's rate. The sharp decline was the steepest since March and the ninth drop in the past twelve months. Second, rates for June, July, and August were all revised downward. Before the revisions, the average sales rate for the three months stood at 556,000 units; the new figures yield a sales rate of 543,000 units.

The revisions and September's low figure place the third-quarter sales rate 2.2 percent below the second quarter's pace. The NAR forecast calls for the rate to fall another 3.6 percent by the first quarter of 1991 before begining a slow climb. The annual figure for 1991 is projected to be 520,000 units, more than 20 percent below the 1989 figure. Although 1992 will be a year of recovery, the annual rate will stand 18 percent below the 1989 figure.

All regions of the country suffered declines in the sales rate in September. The largest drop was recorded in the Northeast, which sustained a 16 percent decline. The South fell by 8 percent, and the Midwest dropped 2 percent. The West recorded the smallest decline -- less than 1 percent -- but nevertheless the region's sales rate stands at less than two-thirds of the rate recorded a year earlier.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

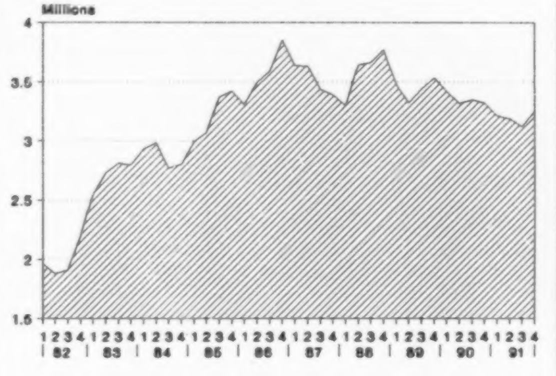
		Mo. Ago % Chg.	Yr. Ago % Chg.
Sep 1989	3,510	2.0	-3.8
Oct 1989	3,490	-0.6	-5.2
Nov 1989	3,560	2.0	-4.0
Dec 1989	3,560	0.0	-9.2
Jan 1990	3,470	-2.5	-5.2
Feb 1990	3,400	-2.0	-4.2
Mar 1990	3,400	0.0	-0.9
Apr 1990	3,330	-2.1	-3.2
May 1990	3,300	-0.9	1.5
Jun 1990	3,330	0.9	0.0
Jul 1990	3,330	0.0	-1.5
Aug 1990	3,500	5.1	1.7
Sep 1990	***3,220***	***-8.0***	***-8.3***
Annual Averages:			
1988	3,594		-1.9
1989	3,467		-3.6

Regional Data

	Northeast	Midwest	South	West
Sep 1989	600	960	1320	620
Apr 1990	520	920	1300	580
May 1990	520	880	1320	570
Jun 1990	490	960	1310	580
Jul 1990	560	930	1310	530
Aug 1990	520	990	1400	570
Sep 1990	***520***	***920***	***1260***	***520***
Annual Averages:				
1988	669	929	1348	643
1989	590	931	1320	617
Percent changes in September 1990 since:				
Sep 1989	-13.3	-4.2	-4.5	-16.1
Aug 1990	0.0	-7.1	-10.0	-8.8

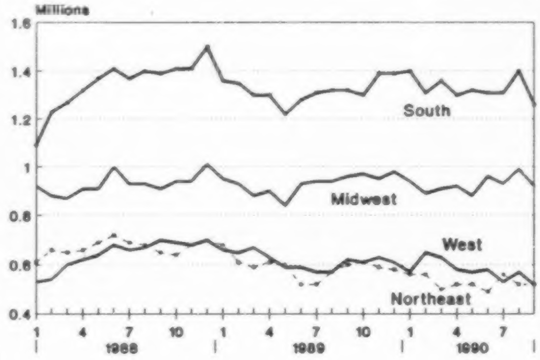
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

After posting a sizable gain in August, the annual sales rate for existing homes dropped by 8 percent in September to 3,220,000 units, the lowest level since January 1988. In addition, revised figures released with the most recent data also scaled back July's gain. Initially reported at a 3.3 percent increase over June, the new figures show no change for the month.

Although the third quarter's sales rate of 3,350,000 bested the second quarter's by 1 percent, the September figure, coupled with the uneasiness over the direction of the economy, lead the NAR forecast to call for further declines in the sales rate. The low point is expected to come during the second quarter of 1991, when the sales pace is expected to hit 3,203,000 units. For 1991 relative to 1990, the rate is expected to fall 2.9 percent. A modest but sustainable recovery beginning in mid-1991 is expected to bring the 1992 rate up by 3.1 percent. The market will be helped by lower mortgage rates -- the 30-year rate is expected to average 9.4 percent in 1992.

While the housing market is in a slump, it isn't moribund. Both the Northeast and the South reversed decreases in the sales rate in July by picking up 14.3 percent and 6.9 percent, respectively. The South's 1,400,000-unit annual rate during July was stronger than the region's annual rates in both 1988 and 1989. The Midwest's July rate just matches that of the two previous years. The West, however, was about 16 percent off in July from its 1989 performance.

Single-Family Home Prices

(In Dollars)

National Data

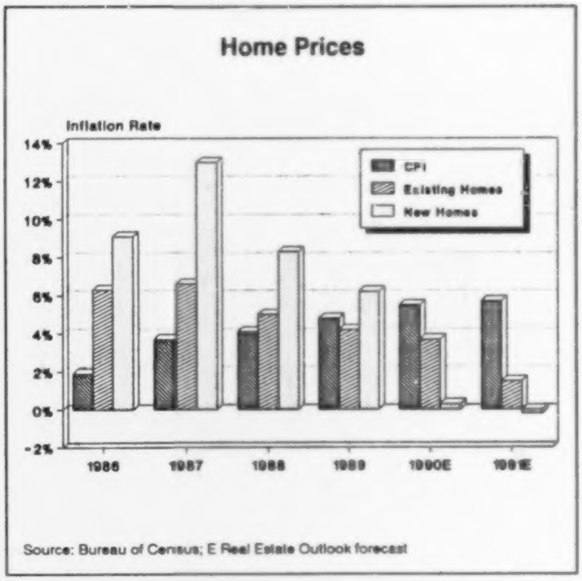
	Median		Average	
	Existing	New	Existing	New
Sep 1989	93,800	120,000	118,300	151,100
Apr 1990	95,600	130,000	117,800	153,400
May 1990	95,600	125,000	118,700	150,600
Jun 1990	97,500	125,000	121,100	150,400
Jul 1990	98,300	119,900	122,000	149,700
Aug 1990	97,100	118,400	120,500	144,600
Sep 1990	***94,300***	***115,000***	***116,500***	***142,300***
Annual Averages:				
1988	89,200	113,400	112,500	138,900
1989	92,900	120,400	118,000	148,300
Percent changes in September 1990 since:				
Sep 1989	0.5	-4.2	-1.5	-5.8
Aug 1990	-2.9	-2.9	-3.3	-1.6

Regional Data

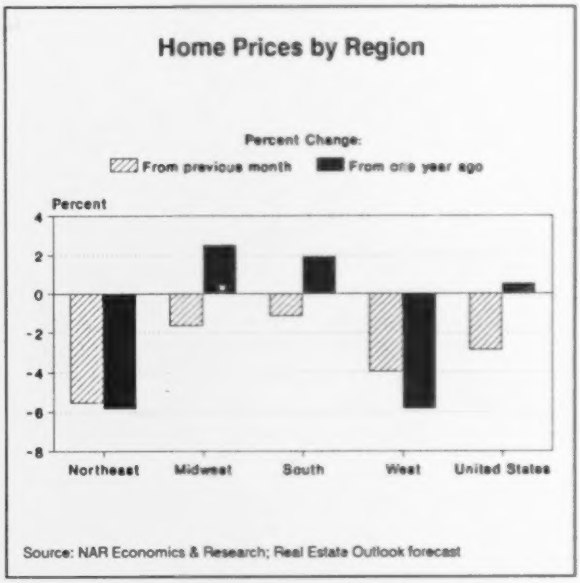
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Sep 1989	145,700	72,200	84,300	143,100
Apr 1990	140,700	75,300	85,900	137,600
May 1990	141,300	73,500	85,100	141,800
Jun 1990	148,300	75,900	87,500	138,100
Jul 1990	146,900	76,000	88,800	139,700
Aug 1990	145,300	75,300	86,900	140,240
Sep 1990	***137,100***	***74,000***	***85,900***	***134,700***
Annual Averages:				
1988	142,500	68,200	82,200	124,700
1989	145,100	71,200	84,400	139,800
Percent changes in September 1990 since:				
Sep 1989	-5.9	2.5	1.9	-5.9
Aug 1990	-5.6	-1.7	-1.2	-4.0

Source: National Association of Realtors,® 'Home Sales'



Source: Bureau of Census; E Real Estate Outlook forecast



Source: NAR Economics & Research; Real Estate Outlook forecast

Median prices of existing and new single-family homes both fell by 2.9 percent in September. The median price for existing homes stands at $94,300, up $500, or 0.5 percent, from its level of a year ago. The median price has fallen $4,000 since its recent peak in July. The median price for new homes stands at $115,000, down $5,000, or 4.2 percent, from its year-ago level. It has not advanced in any month since April, when it stood at $130,000.

Average prices also fell in September for both new and existing homes. The decline for existing homes places the average $1,800, or 1.5 percent, below its year-ago level; the average for new homes stands $8,800, or 5.8 percent, below its year-ago level.

The unequal regional difficulties in housing markets is reflected in the median prices for existing homes. Although all four regions lost ground in September relative to August, the Midwest and the South suffered milder declines. Relative to year-ago figures, both the Northeast and the West lost 5.9 percent, while the Midwest and the South have posted gains, of 2.5 percent and 1.9 percent, respectively.

The median price on new homes is projected to fall 0.2 percent in 1991, while the median price on existing homes is expected to gain 1.5 percent.

Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis Division

BUBBLE BATHOS

Introduction

One of the most talked about and least understood provisions of the 1986 Tax Reform Act (TRA) is the "bubble" created by the 33-percent marginal tax rate imposed on some upper middle-income taxpayers. As one senator said on the Senate floor during recent debates on the 1991 budget, the bubble may be the first tax provision to be repealed because it was too complicated.

The final version of the Omnibus Budget Reconciliation Act of 1990 eliminated the current bubble as predicted. However, a new bubble affecting a higher income range was adopted in its stead. While the mechanical structure of the new bubble differs from the current bubble, many of the issues raised in regard to the current bubble also apply to the new bubble. In fact the purpose of the new bubble is the same as that of the current bubble: to extract higher revenue without directly increasing income tax rates.

Technically, TRA collapsed the number of marginal tax brackets from 14 to 2, a 15-percent bracket on the first increments of income earned and a 28-percent bracket on additional income. However, a 5-percent surcharge was added on taxable income of some upper middle-income taxpayers in order to prevent TRA from losing revenue compared to the previous tax system. This 5-percent surcharge pushes the marginal tax rate for these taxpayers from 28 to 33 percent thereby creating, in effect, a third marginal tax bracket. Eventually, at higher taxable income levels the marginal tax rate drops once again to 28-percent. Consequently, a married couple with a taxable income of $80,000 faces a 33-percent marginal tax rate while another couple with a taxable income of $200,000 faces only a 28-percent marginal tax rate.

The drop in the marginal tax rate for the higher-income couple has led many individuals, mistakenly, to believe that the marginal-tax-rate bubble creates an average-tax-rate bubble that causes the lower-income couple's total tax liability as a share of their income subject to tax to exceed that of the higher-income couple. As a result of this widespread misperception, some members of Congress proposed to burst the marginal-tax-rate bubble by extending the 33-percent marginal-tax-rate bracket to include the highest-income taxpayers in order, they believe, to confer a greater degree of fairness on the tax system.

After much negotiation, Congress eventually agreed to eliminate the current bubble by dropping the 5-percent surcharge and increasing the top marginal tax rate to 31 percent. In addition, Congress agreed to phase out the benefit of personal exemptions at the rate of 2 percent for every $2,500 above an adjusted gross income of $100,000 for single taxpayers and $150,000 for couples filing jointly. This phaseout provision will create a new marginal-tax-rate bubble for single taxpayers with income between $100,000 and $225,000 and for couples with income between $150,000 and $275,000. The marginal rate for taxpayers in this range will be increased by nearly 0.5 percent per personal exemption claimed. Although the NATIONAL ASSOCIATION OF REALTORS® took no position with respect to proposals to eliminate the current bubble, several aspects of this issue still merit detailed consideration.

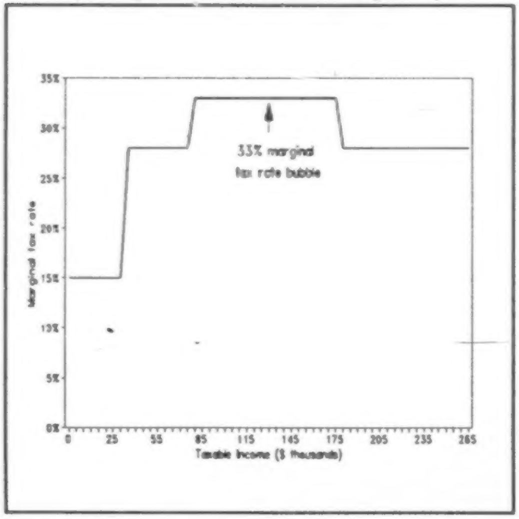
Many tax experts would argue that neither the current bubble nor the new bubble is or will be unfair in the sense that the tax liability of some upper-middle-income taxpayers is proportionally higher than that of the highest-income taxpayers. In fact, both bubbles actually are designed to increase the proportional tax liability of higher-income taxpayers relative to that of lower-income taxpayers, i.e., to make the tax system more progressive. The perception that either bubble taxes or will tax some upper-middle-income taxpayers disproportionately more than the highest-income taxpayers is caused partly by a misunderstanding of the difference between marginal and average tax rates and partly by confusion about the definition of average, or effective, tax rates. The remainder of this paper is devoted to dispelling misconceptions about the effect of marginal-tax-rate bubbles on average tax rates with particular emphasis on the current bubble, followed by a discussion of the effect of the new bubble and the new limit on itemized deductions created by the 1990 Budget Act.

The Mechanics of the Bubble

The reason that the 5-percent surcharge on taxable income in the current bubble range does not cause a disproportionate rise in tax liability is that taxpayers with taxable income in this range benefit to some extent because the first $30,950 of a joint filer's taxable income and the first $18,600 of a single filer's income are taxed at only 15 percent and because their taxable income is reduced by personal exemptions. Taxing the first increments of income at 15 percent instead of 28 percent results in a tax saving of $4,023.50 for joint filers with taxable income in the bubble range. In addition, each $2,000 personal exemption saves $560, a total of $1,120 for joint filers, assuming a marginal tax rate of 28-percent. The surcharge simply serves to phase out these benefits gradually over a broad range of incomes such that individuals with taxable income exceeding the bubble range receive no benefit either from personal exemptions or from the 15-percent rate thereby ensuring that the highest-income taxpayers face a 28-percent tax rate on all their income.

Figure 1 shows the marginal tax rate schedule for joint filers claiming two personal exemptions. The 5-percent surcharge creates a bubble in the marginal tax rate for joint filers with taxable income between $74,850 and $177,720. At $155,320 of taxable income the $4,023.50 benefit from the 15-percent rate applied to the first $30,950 of taxable income is completely eliminated by the 5-percent surcharge. The $1,120 benefit from two personal exemptions is recaptured by applying the 5-percent surcharge to taxable income between $155,320 and $177,720.

Figure 1
Marginal Tax Rate Bubble
(1989 joint return, two exemptions)



The Average-Tax-Rate Bubble Controversy

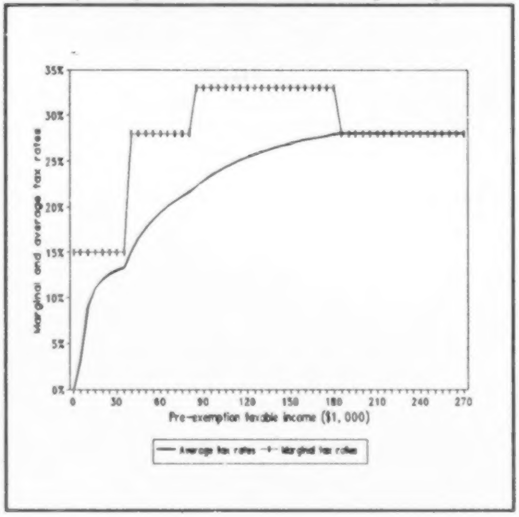
The fact that a marginal-tax-rate bubble exists, by itself, says little about the vertical equity of a tax system. What matters is whether the marginal-tax-rate bubble creates an average-tax-rate bubble. The average tax rate is the best measure for equity comparison purposes since it measures total tax liability as a share of taxable income. The marginal tax rate, in contrast, does not measure the true burden of tax liability since it only measures the additional tax liability resulting from the last increment of taxable income. A joint filer with taxable income of $100,000 and claiming two exemptions is subject to a 33-percent marginal tax rate, but his average tax rate is only 25.2 percent.

A controversy has arisen among tax experts not about the fairness of the marginal-tax-rate bubble per se, but about whether the current marginal-tax-rate bubble causes a significant average-tax-rate bubble. The existence of an average-tax-rate bubble hinges on the definition of average tax rate. Historically, the average tax rate has been defined as taxes paid divided by taxable income, where the latter equals adjusted gross income minus personal exemptions minus itemized deductions for itemizers or adjusted gross income minus the standard deduction minus personal exemptions for nonitemizers.

Such a definition was logical before TRA because personal exemptions were not taxed and therefore should not have been included in the denominator of the average tax rate. At a certain taxable income level, however, TRA imposes a 5-percent surcharge on taxable income above the threshold until the benefit of all personal exemptions is phased out. The benefit of personal exemptions is completely taxed away for individuals with taxable incomes above the bubble range. Thus, for the highest-income taxpayers, it makes little sense to measure taxable income as adjusted gross income less personal exemptions when the benefit of personal exemptions is completely eliminated by the 5-percent surcharge.

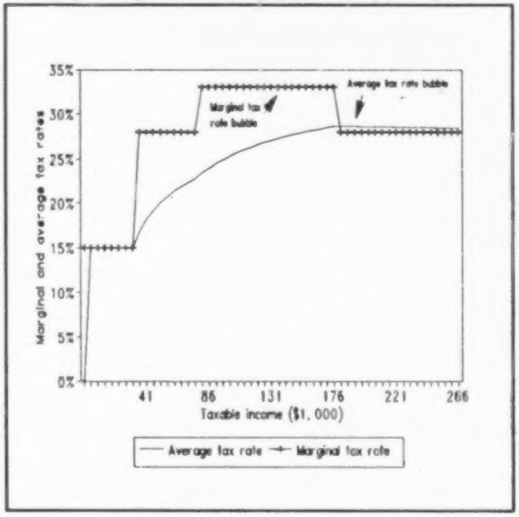
As a result, some tax experts argue that the definition of the denominator should be modified to include personal exemptions.[1] Increasing the size of the denominator, naturally, reduces the average tax rate calculated. In fact, for taxpayers with income below the bubble range, increasing the denominator by including personal exemptions results in a significantly understated average tax rate since these taxpayer's taxable incomes are reduced by the full amount of the allowable personal exemptions.

Figure 2
Marginal and Average Tax Rates Using Pre-exemption Taxable Income as the Base
(1989 joint return, two exemptions)



Other tax experts contend that because the Internal Revenue Service continues to define average tax rate the same way it always has, it is inappropriate to change the definition.[2] Figure 2 shows that no average-tax-rate bubble occurs using taxable income plus exemptions as the denominator.

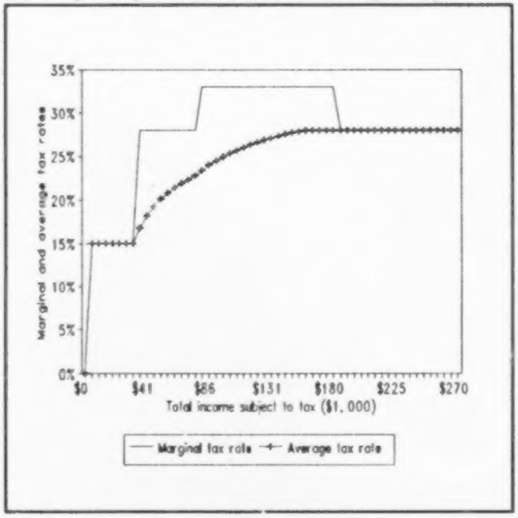
Figure 3
Marginal and Average Tax Rates Using Taxable Income as the Base
(1989 joint return, two exemptions)



However, Figure 3 reveals that when taxable income is used as the denominator, a small bubble results in the average tax rate. This bubble, though, is many orders of magnitude smaller than the marginal-tax-rate bubble and applies only to those with taxable incomes above $155,000.

An alternative definition which is defensible from the perspective of economic theory would add to the taxable income base only the amount of income that is taxed additionally to recover the benefit of personal exemptions. Figure 4 demonstrates that no average-tax-rate bubble occurs when the alternative definition is applied. Effective tax rates using the alternative definition are calculated in the table on the next page for three sample returns.

Figure 4
Marginal and Average Tax Rates Using Income Subject to Tax as the Base
(1989 joint return, two exemptions)



As the table shows, a joint filer claiming two exemptions with taxable income of $100,000 has a marginal tax rate of 33 percent. Yet, the total amount of taxes he actually pays is only 25.23 percent of income subject to tax. In comparison, a joint filer claiming two exemptions with taxable income of $180,000 has a marginal tax rate of only 28 percent, but his total tax bill is also 28 percent of income subject to tax ($184,000). When this joint filer's taxable income exceeds $177,720, the maximum amount subject to the 5-percent surcharge, his marginal tax rate becomes his average tax rate.

Sample Tax Calculation
Comparing Effective Tax Rates for Three Income Levels
(Joint return, two exemptions, 1989 rates)

Taxable Income (Line 37 of Form 1040)	**$50,000**	**$100,000**	**$180,000**
Tax:			
15% bracket (0-$30,950)	$4,642.50	$4,642.50	$4,642.50
28% bracket (above $30,950)	$5,334.00	$19,334.00	$41,734.00
5% surtax bracket to eliminate benefit of 15% rate ($74,850 to $155,320)	0	$1,257.50	$4,023.50
5% surtax bracket to eliminate benefit of personal exemptions ($155,321 to $177,720)	0	0	$1,120.00
Tax liability	$9,976.50	$25,234.00	$51,520.00
Divided by total income subject to tax	$50,000.00	$100,000.00	$184,000.00
Effective tax rate	19.95%	25.23%	28%

An Historical Perspective on the Bubble

Why politicians agreed to such a complicated and seemingly unfair tax provision is perhaps easier to understand if put into an historical context. Contrary to contentions otherwise, the bubble is the result of a peculiar quirk in the tax code that was designed as part of the Tax Reform Act of 1986 to make the tax system more progressive.

In the final stages of negotiations on TRA, as agreement was reached to drop the top tax rate from 50 percent to 28 percent and to collapse the number of tax brackets, it was estimated that, unless amended, TRA as conceived would yield less in revenue than the existing tax system. In an effort to ensure revenue neutrality and inject greater progressiveness, a group of lawmakers proposed an additional 33-percent top rate on the highest income groups. The delicate coalition supporting the top rate of 28 percent threatened to come apart over the proposal for a third higher bracket.

To keep the coalition from dissolving, the Senate Finance Committee staff suggested that it would be possible to keep just two rates and still generate the needed revenue by taking away the benefit of the 15-percent initial rate on the first increments of income and all personal exemptions for taxpayers with taxable incomes above $170,000. As a result, higher-income taxpayers would pay the full 28-percent top rate on all their income. This proposal, while it would have kept just two rates, would have created an abrupt jump in tax liability as taxpayers reached the $170,000 threshold.

If this proposal had been adopted, the actual tax liability for individuals earning $170,000 would have been $5,144 more than the tax liability for individuals earning $169,999. Earning an extra dollar at this income level would have increased a taxpayer's tax liability by $5,144. The point where the average tax rate would have jumped abruptly to 28 percent is shown in Figure 5. The only way to avoid such a jump would be to phase out the benefits gradually, starting well before the $170,000 level. Congress eventually decided to apply a surcharge on higher-income taxpayers in order to phase out both the benefit of the 15-percent rate applied to the first increments of income and the benefit of personal exemptions. Such a surcharge is not unique in the tax code. Similar provisions phasing out benefits appear elsewhere in the tax code.

F [illegible]
Effect of Bubble [illegible] ge Tax Rates
Using Income Subject [illegible] as the Base
(1989 joint return, two exemptions)

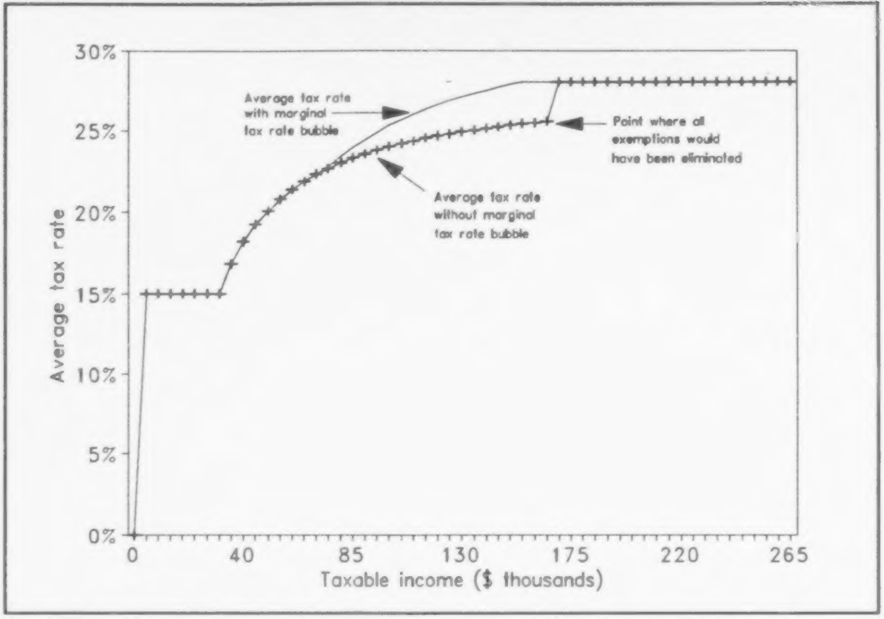


Figure 5 shows how the 5-percent surcharge which creates the bubble for upper middle-income taxpayers actually made TRA more progressive than originally proposed without causing a surge in the effective tax rate. Note that for incomes between $74,850 and $170,000, the average tax rate under current law lies above the average tax rate that would have applied had Congress adopted the Finance Committee staff plan with the $170,000 threshold. The graph shows that higher-income taxpayers face a higher tax liability as a percentage of their income than all other individuals.

The Effect of Bursting the Bubble

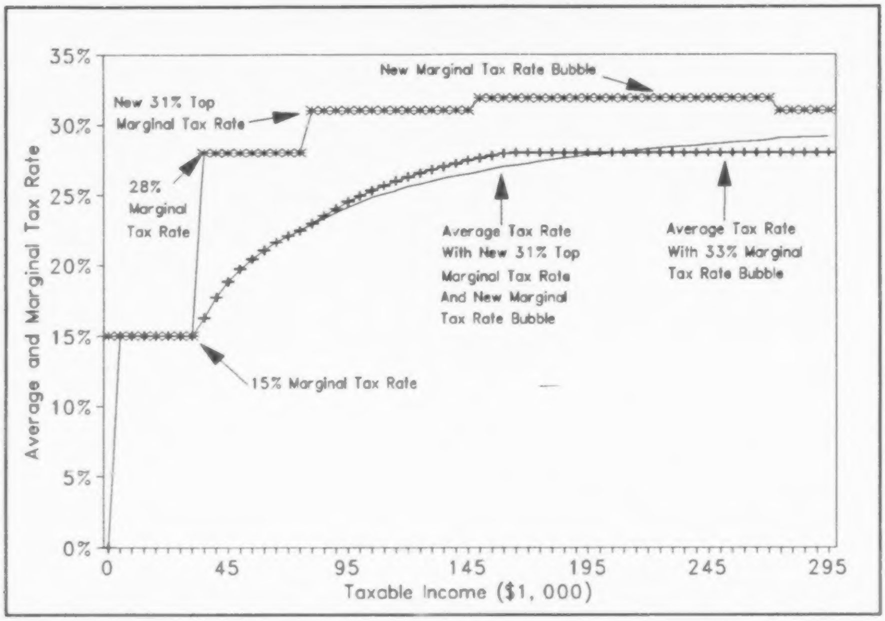
Recent budget negotiations focused on ways to raise revenue. High on many lawmakers' lists of possible tax increases was a proposal to burst the bubble by extending the 33-percent top tax rate to all taxable incomes above the current bubble. One common plan to burst the bubble would have eliminated the 5-percent surtax to phase out benefits and created, instead, an explicit top bracket of 33 percent for taxable income starting where the phaseouts begin currently, e.g., $74,850 for a joint filer claiming two exemptions.

After weeks of wrangling over the budget, Congress finally agreed to eliminate the current 33-percent marginal-tax-rate bubble and create a top marginal tax rate of 31 percent beginning where the bubble range starts currently. A new marginal-tax-rate bubble phasing out the benefit of personal exemptions would affect single taxpayers with taxable income between $100,000 and $225,000 and married couples with taxable income between $150,000 and $275,000. The new bubble will increase the marginal tax rate for affected taxpayers approximately 0.5 percent for each exemption claimed.

Figure 6 shows the new bubble for affected couples claiming only two exemptions. The new bubble will raise their marginal tax rate to nearly 32 percent. For couples with taxable income above $275,000 the marginal tax rate will drop back to 31 percent. As Figure 6 shows, however, the average tax rate, using income subject to tax as the base, never declines.

Comparison of the two average tax rate curves depicted in Figure 6 reveals that many taxpayers currently affected by the bubble will benefit from an average-tax-rate reduction because their marginal tax rate will drop from 33 percent to 31 percent. Other tax code changes such as limiting itemized deductions and increasing the maximum income limit for the medicare tax could

Figure 6
Average Tax Rates
Using Income Subject to Tax as the Base
Current Law versus 1990 Budget Act
(1990 joint return, two exemptions)



more than offset the benefit of the drop in marginal tax rates for individuals currently affected by the bubble.

Relationship to Other Proposals

In addition to modifying the bubble, Congress also decided to limit itemized deductions such as mortgage interest by allowing deductions only above a certain threshold. Allowable itemized deductions will be reduced by $300 for every $10,000 of taxable income in excess of $100,000, indexed for inflation, for both single and joint filers, not to exceed 80 percent of total itemized deductions. Under the new law, a taxpayer with a $150,000 income will not be able to deduct the first $1,500 of itemized deductions, resulting in a $495 tax increase assuming the taxpayer has itemized deductions of at least $1,500.

Distributional Impacts

Raising the top marginal tax rate to 31 percent will increase taxes for taxpayers with taxable income above approximately $200,000 for joint return filers and above roughly $100,000 for single return filers, the exact amounts depending on the number of exemptions claimed. Likewise, limiting itemized deductions as discussed above will increase taxes for all taxpayers filing itemized returns, single or married, with adjusted gross income above $100,000. As noted earlier, replacing the bubble with a 31-percent top marginal tax rate will reduce the average tax rate for taxpayers in the current bubble range. In contrast, the income tax liability for all other taxpayers with incomes below the current bubble range will remain unchanged by either the new limitation on itemized deductions or the new top marginal tax rate.

While limiting itemized deductions will reduce the value of such deductions to taxpayers with incomes above $100,000, increasing the top rate to 31 percent could, on net, increase the value of itemized deductions for many taxpayers above the bubble range, depending on the amount of itemized deductions claimed. A taxpayer with adjusted gross income of, say, $250,000 will not be allowed to claim the first $4,500 of itemized deductions since itemized deductions will be limited to deductions in excess of 3 percent of income above $100,000 which in this case amounts to 3 percent of $150,000 or $4,500. At a 31-percent marginal tax rate, the $4,500 limitation translates into a $1,395 loss in tax benefits (.31 x

$4,500). This $1,395 loss is completely recovered under the higher tax rate, however, if this taxpayer has itemized deductions of at least $46,500. For example, when itemized deductions reach $46,500, the tax benefit is $14,415 at a 31-percent marginal tax rate and only $13,020 at a 28-percent marginal tax rate resulting in a difference of $1,395, an amount which just offsets the tax loss from limiting itemized deductions.

Conclusion

To the casual observer at this point, the bubble probably seems like an overly complicated and trivial aspect of a mind-boggling tax system. Whether the bubble is the most efficient method to phase out the benefits of the 15-percent tax rate and personal exemptions is an issue beyond the scope of this paper. The facts concerning the bubble speak plainly, however: 1) The current bubble in the marginal tax rates does not cause any taxpayer to be subject to a higher average tax rate than another taxpayer with higher income subject to tax; 2) The new marginal-tax-rate bubble also will not cause any taxpayer to be subject to a higher average tax rate than another taxpayer with higher income subject to tax.

References

Abbin, Byrle M. "The Bubble is No Anomaly," *Tax Notes*, October 2, 1989, p. 119.

______________ "The Bubble's Common Denominator," *Tax Notes*, July 2, 1990, pp. 117-119.

Charvonitz, Steve, "Yes, the Bubble Really Exists," *Tax Notes*, June 18, 1990, pp. 1521-1523.

Commerce Clearing House, *Internal Revenue Code of 1986*, Commerce Clearing House, Inc., 1986, pp. 4275-4276.

Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options*, U.S. Government Printing Office, Washington, D.C., 1990.

Joint Committee on Taxation, *Estimates of Federal Tax Expenditures For Fiscal Years 1988-1992*, U.S. Government Printing Office, Washington, D.C., 1987.

by
Donald R. Leavens
Director of Tax Research
Forecasting and Policy Analysis Division

---

[1] See Byrle M. Abbin, "The Bubble is No Anomaly," *Tax Notes*, October 2, 1989, p. 119.

[2] See Steve Charvonitz, "Yes, the Bubble Really Exists," *Tax Notes*, July 2, 1990, pp. 117-119.

Existing Home Sales

Thousands of Units; Percent Change from One Month Ago; Percent Change from One Year Ago

	U.S.			Northeast			Midwest			South			West			
86.01	3,400	-1.2	13.3	730	5.8	28.1	910	-2.2	13.8	1,210	-1.6	9.0	540	-6.9	3.8	86.01
86.02	3,350	-1.5	13.6	680	-6.8	25.9	920	1.1	21.1	1,180	-2.5	4.4	560	3.7	5.7	86.02
86.03	3,270	-2.4	7.9	640	-5.9	12.3	950	3.3	20.3	1,110	-5.9	-2.6	570	1.8	5.6	86.03
86.04	3,580	9.5	18.2	710	10.9	24.6	1,070	12.6	33.8	1,220	9.9	7.0	590	3.5	11.3	86.04
86.05	3,440	-3.9	12.8	690	-2.8	21.1	980	-8.4	19.5	1,200	-1.6	8.1	580	-1.7	5.5	86.05
86.06	3,460	0.6	10.5	670	-2.9	9.8	990	1.0	16.5	1,220	1.7	8.9	580	0.0	5.5	86.06
86.07	3,510	1.4	9.7	680	1.5	7.9	950	-4.0	4.4	1,280	4.9	10.3	600	3.4	17.6	86.07
86.08	3,600	2.6	3.4	690	1.5	4.5	1,000	5.3	5.3	1,280	0.0	0.0	630	5.0	8.6	86.08
86.09	3,670	1.9	7.0	710	2.9	4.4	1,020	2.0	8.5	1,320	3.1	9.1	620	-1.6	3.3	86.09
86.10	3,670	0.0	7.0	720	1.4	4.3	1,000	-2.0	6.4	1,310	-0.8	7.4	650	4.8	10.2	86.10
86.11	3,860	5.2	13.5	710	-1.4	6.0	1,040	4.0	13.0	1,450	10.7	17.9	660	1.5	15.8	86.11
86.12	3,970	2.8	15.4	810	14.1	17.4	1,060	1.9	14.0	1,370	-5.5	11.4	730	10.6	25.9	86.12
87.01	3,580	-9.8	5.3	680	-16.0	-6.8	1,030	-2.8	13.2	1,270	-7.3	5.0	610	-16.4	13.0	87.01
87.02	3,730	4.2	11.3	720	5.9	5.9	1,080	4.9	17.4	1,310	3.1	11.0	620	1.6	10.7	87.02
87.03	3,770	1.1	15.3	740	2.8	15.6	1,120	3.7	17.9	1,320	0.8	18.9	590	-4.8	3.5	87.03
87.04	3,580	-5.0	0.0	680	-8.1	-4.2	1,020	-8.9	-4.7	1,280	-3.0	4.9	600	1.7	1.7	87.04
87.05	3,740	4.5	8.7	720	5.9	4.3	1,000	-2.0	2.0	1,390	8.6	15.8	630	5.0	8.6	87.05
87.06	3,520	-5.9	1.7	690	-4.2	3.0	910	-9.0	-8.1	1,280	-7.9	4.9	640	1.6	10.3	87.06
87.07	3,500	-0.6	-0.3	690	0.0	1.5	930	2.2	-2.1	1,260	-1.6	-1.6	620	-3.1	3.3	87.07
87.08	3,380	-3.4	-6.1	670	-2.9	-2.9	870	-6.5	-13.0	1,260	0.0	-1.6	580	-6.5	-7.9	87.08
87.09	3,400	0.6	-7.4	670	0.0	-5.6	900	3.4	-11.8	1,270	0.8	-3.8	560	-3.4	-9.7	87.09
87.10	3,430	0.9	-6.5	660	-1.5	-8.3	910	1.1	-9.0	1,280	0.8	-2.3	580	3.6	-10.8	87.10
87.11	3,330	-2.9	-13.7	660	0.0	-7.0	890	-2.2	-14.4	1,230	-3.9	-15.2	560	-3.4	-15.2	87.11
87.12	3,240	-2.7	-18.4	640	-3.0	-21.0	860	-3.4	-18.9	1,190	-3.3	-13.1	560	0.0	-23.3	87.12
88.01	3,200	-1.2	-10.6	610	-4.7	-10.3	920	7.0	-10.7	1,090	-8.4	-14.2	530	-5.4	-13.1	88.01
88.02	3,320	3.8	-11.0	660	8.2	-8.3	880	-4.3	-18.5	1,230	12.8	-6.1	540	1.9	-12.9	88.02
88.03	3,382	1.9	-10.3	650	-1.5	-12.2	870	-1.1	-22.3	1,270	3.3	-3.8	600	11.1	1.7	88.03
88.04	3,510	3.8	-2.0	660	1.5	-2.9	910	4.6	-10.8	1,320	3.9	3.1	620	3.3	3.3	88.04
88.05	3,620	3.1	-3.2	690	4.5	-4.2	910	0.0	-9.0	1,370	3.8	-1.4	640	3.2	1.6	88.05
88.06	3,800	5.0	8.0	720	4.3	4.3	1,000	9.9	9.9	1,410	2.9	10.2	680	6.3	6.3	88.06
88.07	3,650	-3.9	4.3	690	-4.2	0.0	930	-7.0	0.0	1,370	-2.8	8.7	660	-2.9	6.5	88.07
88.08	3,690	1.1	9.2	680	-1.4	1.5	930	0.0	6.9	1,400	2.2	11.1	670	1.5	15.5	88.08
88.09	3,650	-1.1	7.4	650	-4.4	-3.0	910	-2.2	1.1	1,390	-0.7	9.4	700	4.5	25.0	88.09
88.10	3,680	0.8	7.3	640	-1.5	-3.0	940	3.3	3.3	1,410	1.4	10.2	690	-1.4	19.0	88.10
88.11	3,710	0.8	11.4	680	6.3	3.0	940	0.0	5.6	1,410	0.0	14.6	680	-1.4	21.4	88.11
88.12	3,920	5.7	21.0	700	2.9	9.4	1,010	7.4	17.4	1,500	6.4	26.1	700	2.9	25.0	88.12
89.01	3,660	-6.6	14.4	680	-2.9	11.5	950	-5.9	3.3	1,360	-9.3	24.8	660	-5.7	24.5	89.01
89.02	3,550	-3.0	6.9	610	-10.3	-7.6	930	-2.1	5.7	1,350	-0.7	9.8	650	-1.5	20.4	89.02
89.03	3,430	-3.4	1.4	590	-3.3	-9.2	880	-5.4	1.1	1,300	-3.7	2.4	670	3.1	11.7	89.03
89.04	3,440	0.3	-2.0	610	3.4	-7.6	900	2.3	-1.1	1,300	0.0	-1.5	630	-6.0	1.6	89.04
89.05	3,250	-5.5	-10.2	600	-1.6	-13.0	840	-6.7	-7.7	1,220	-6.2	-10.9	590	-6.3	-7.8	89.05
89.06	3,330	2.5	-12.4	520	-13.3	-27.8	930	10.7	-7.0	1,280	4.9	-9.2	590	0.0	-13.2	89.06
89.07	3,380	1.5	-7.4	520	0.0	-24.6	940	1.1	1.1	1,310	2.3	-4.4	570	-3.4	-13.6	89.07
89.08	3,440	1.8	-6.8	570	9.6	-16.2	940	0.0	1.1	1,320	0.8	-5.7	570	0.0	-14.9	89.08
89.09	3,510	2.0	-3.8	600	5.3	-7.7	960	2.1	5.5	1,320	0.0	-5.0	620	8.8	-11.4	89.09
89.10	3,490	-0.6	-5.2	610	1.7	-4.7	970	1.0	3.2	1,300	-1.5	-7.8	610	-1.6	-11.6	89.10
89.11	3,560	2.0	-4.0	590	-3.3	-13.2	950	-2.1	1.1	1,390	6.9	-1.4	630	3.3	-7.4	89.11
89.12	3,560	0.0	-9.2	580	-1.7	-17.1	980	3.2	-3.0	1,390	0.0	-7.3	610	-3.2	-12.9	89.12
90.01	3,470	-2.5	-5.2	560	-3.4	-17.6	940	-4.1	-1.1	1,400	0.7	2.9	570	-6.6	-13.6	90.01
90.02	3,400	-2.0	-4.2	560	0.0	-8.2	890	-5.3	-4.3	1,310	-6.4	-3.0	650	14.0	0.0	90.02
90.03	3,400	0.0	-0.9	500	-10.7	-15.3	910	2.2	3.4	1,360	3.8	4.6	630	-3.1	-6.0	90.03
90.04	3,330	-2.1	-3.2	520	4.0	-14.8	920	1.1	2.2	1,300	-4.4	0.0	580	-7.9	-7.9	90.04
90.05	3,300	-0.9	1.5	520	0.0	-13.3	880	-4.3	4.8	1,320	1.5	8.2	570	-1.7	-3.4	90.05
90.06	3,330	0.9	0.0	490	-5.8	-5.8	960	9.1	3.2	1,310	-0.8	2.3	580	1.8	-1.7	90.06
90.07	3,330	0.0	-1.5	560	14.3	7.7	930	-3.1	-1.1	1,310	6.9	6.9	530	-10.3	-8.8	90.07
90.08	3,500	5.1	1.7	520	-7.1	-8.8	990	6.5	5.3	1,400	6.9	6.1	570	7.5	0.0	90.08
90.09	3,220	-8.0	-8.3	520	0.0	-13.3	920	-7.1	-4.2	1,260	-10.0	-4.5	520	-8.8	-16.1	90.09

Source: NATIONAL ASSOCIATION OF REALTORS

U.S. Economic Outlook: November 1990

Quarterly figures are seasonally adjusted annual rates

	90.2	90.3	90.4	91.1	91.2	91.3	91.4	92.1	1988	1989	1990	1991	1992
U.S. Economy													
Annual Growth Rate													
Real GNP	0.4	1.8	-0.9	-1.6	0.9	2.8	3.6	3.2	4.5	2.5	1.1	0.4	3.0
Industrial Production	4.1	3.7	1.9	-3.4	0.2	3.2	5.3	4.1	5.4	2.6	1.6	0.9	3.8
Civilian Employment	0.7	-1.5	-0.9	-0.4	-0.2	0.7	1.3	1.4	2.3	2.0	0.5	-0.3	1.3
GNP Inflation Index	4.7	4.6	5.6	5.8	4.0	3.3	3.4	3.7	3.3	4.1	4.4	4.8	3.4
Consumer Prices	3.7	7.9	6.0	6.8	4.8	4.0	4.0	3.8	4.1	4.8	5.5	5.7	4.0
Value of the U.S. Dollar	-2.0	-21.4	-13.9	-10.4	-6.1	-0.2	-0.3	0.7	-4.3	6.2	-9.4	-9.5	0.5
Percent													
Mfg. Capacity Utilization	82.7	82.8	83.1	81.9	81.4	81.4	81.7	81.8	83.9	83.9	82.8	81.6	82.0
Civilian Unemployment	5.3	5.5	5.9	6.2	6.4	6.4	6.3	6.2	5.5	5.3	5.5	6.3	6.0
Percent of GNP													
Federal Tax Receipts	20.3	20.2	20.3	20.5	20.4	20.3	20.3	20.5	20.0	20.2	20.2	20.4	20.5
Federal Expenditures	23.4	23.0	22.9	23.1	23.1	22.9	22.7	22.6	22.9	22.8	23.1	22.9	22.4
Federal Budget Deficit	-3.0	-2.8	-2.6	-2.7	-2.7	-2.6	-2.4	-2.1	-2.9	-2.6	-2.9	-2.6	-1.9
Interest Rates, Percent													
Federal Funds Rate	8.2	8.2	7.8	7.6	7.5	7.5	7.6	7.6	7.6	9.2	8.1	7.5	7.6
3-Month T-Bill Rate	7.7	7.5	7.3	7.1	7.0	7.1	7.1	7.2	6.7	8.1	7.6	7.1	7.1
Prime Rate	10.0	10.0	9.9	9.6	9.5	9.5	9.5	9.5	9.3	10.9	10.0	9.5	9.5
Discount Rate	7.0	7.0	7.0	6.9	6.8	6.8	6.8	6.8	6.2	6.9	7.0	6.8	6.8
Corporate AAA Bond Yield	9.4	9.4	9.4	9.2	9.1	9.0	9.0	8.9	9.7	9.3	9.3	9.1	8.8
30-Year Government Bond Yield	8.7	8.8	8.8	8.6	8.5	8.4	8.3	8.3	9.0	8.4	8.7	8.4	8.2
Mortgage Rates, Percent													
30-Year Fixed Rate	10.3	10.1	10.1	9.9	9.7	9.6	9.6	9.5	10.3	10.3	10.2	9.7	9.4
1-Year Adjustable	8.6	8.4	8.4	8.3	8.3	8.2	8.2	8.1	8.5	9.3	8.4	8.3	8.1
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	4,188	4,188	4,023	4,044	4,082	4,138	4,173	4,208	4,648	4,446	4,218	4,109	4,252
Existing Single-Family Sales	3,320	3,350	3,211	3,203	3,228	3,240	3,248	3,289	3,594	3,467	3,326	3,230	3,330
New Single-Family Sales	540	528	516	509	515	521	533	544	676	654	544	520	539
Housing Starts	1,204	1,143	1,095	1,145	1,161	1,220	1,271	1,277	1,491	1,386	1,224	1,199	1,298
Single-Family Units	895	864	838	867	881	926	954	947	1,086	1,010	920	907	950
Multi-Family Units	309	279	257	279	280	293	317	330	405	377	304	292	349
2-4 Family Units	44	38	35	38	38	40	43	45	59	55	40	40	48
5+ Family Units	265	241	222	241	242	253	274	285	347	321	264	252	301
Mobile Homes Shipped	190	186	179	186	187	192	198	197	218	199	188	191	197
Percent change – Year Ago													
Total Single-Family Sales	-2.7	-5.0	-10.5	-9.6	-2.5	-1.2	3.7	4.1	0.4	-4.3	-5.1	-2.6	3.5
Existing Single-Family Sales	-0.6	-2.7	-9.2	-6.4	-2.8	-3.3	1.2	2.7	2.4	-3.6	-4.1	-2.9	3.1
New Single-Family Sales	-15.1	-24.5	-20.9	-14.0	-4.6	-1.3	3.3	6.8	0.8	-3.3	-16.8	-4.5	3.8
Housing Starts	-1.1	-14.5	-18.7	-21.2	-3.5	6.7	16.0	11.5	-8.6	-7.0	-11.7	-2.0	8.2
Single-Family Units	-1.0	-13.2	-15.2	-20.0	-1.5	7.2	13.8	9.3	-5.9	-7.0	-8.9	-1.4	4.7
Multi-Family Units	-1.5	-18.5	-28.5	-25.0	-9.3	5.0	23.3	18.5	-14.9	-7.1	-19.2	-3.9	19.3
2-4 Family Units	-1.8	-31.8	-34.0	-12.0	-12.2	5.0	23.3	18.5	-10.0	-5.7	-27.7	-0.3	19.3
5+ Family Units	-1.4	-15.9	-27.5	-26.7	-8.9	5.0	23.3	18.5	-15.7	-7.3	-17.8	-4.5	19.3
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.2	96.6	96.9	97.2	97.3	98.1	98.8	99.3	89.2	92.9	96.4	97.9	100.4
New Home Prices	126.7	117.8	115.4	116.8	118.1	122.1	124.9	125.8	113.4	120.4	120.8	120.5	124.0
Percent Change - Year Ago													
Existing Home Prices	3.5	1.7	4.6	1.3	1.1	1.6	2.0	2.2	5.0	4.2	3.7	1.5	2.6
New Home Prices	6.0	-1.6	-7.2	-5.2	-6.8	3.7	8.2	7.7	8.3	6.2	0.3	-0.2	2.9

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo and Robert Barr.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

REALTOR®

EQUAL HOUSING
OPPORTUNITY

A7000-1

REAL ESTATE OUTLOOK

Vol. 3, No. 12

December 1990

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- Preliminary data suggest that growth in the fourth quarter of 1990 will be negative, and it's widely believed that the following quarter will also show economic contraction. If so, then the usual definition of a recession would be satisfied: Two quarters of negative growth.
- The recession, according to NAR's projections, will be relatively mild, with a decline only about one-third as deep as the average decline in the eight previous post-World War II recessions. A recovery is expected to take root by mid-year, making the two halves of the year dramatically different in terms of economic performance. Measured on a year-over-year basis, economic growth in 1991 will drop to a minuscule 0.1 percent but rebound to 2.8 percent in 1992.
- Housing starts dropped to an annual rate of 1,041,000 during October, marking the ninth consecutive month of decline. The pace is the lowest rate since the end of the last recession in October 1982. Relative to the first ten months of 1989, the pace of housing starts so far this year is down almost 12 percent. Single-family starts are down 8 percent; multi-family starts are down almost 21 percent.
- The new home sales rate dipped below the half-million mark in October, when the annual pace fell 3.5 percent to 491,000 units. Sales of new homes are expected to average 487,000 in the final quarter of 1990, down 7.6 percent from the third quarter. It is possible that the buying opportunities afforded by lower mortgage rates and rising incomes in late 1991 and into 1992 may catch home builders short of supply.
- The deteriorating economy caused existing home sales to decline 4.7 percent to their lowest level in nearly six years. In the two months since posting a sizable gain in August, sales dropped by a cumulative 13.7 percent to stand at an annual rate of 3,020,000 units. The rebound in the economy and lower interest rates will push existing home sales up in the last half of 1991. Sales are projected to be down 3.0 percent in 1991 but up 7.2 percent in 1992.

IN THIS ISSUE

NATIONAL ASSOCIATION OF REALTORS®
REALTOR®
The Voice for Real Estate™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW Washington, D.C. 20005

Copyright 1990 NATIONAL ASSOCIATION OF REALTORS®

The Circle Game

by
John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

A President, recently rebuffed at the polls, struggles to deal with a Mideastern madman holding Americans prisoner; the economy, shocked by rising oil prices, a weakened housing sector and growing inflation, slides toward recession. George Bush and 1990? Wrong. Try Jimmy Carter and 1980. As my more adventuresome graduate school chums used to murmur through the haze, "What goes around comes around." And shocking as it may be, what's going on now in the economy is not only not new, it's not even as interesting.

Economists like to characterize *homo economicus* as the ultimate rational individual, deciding on expenditures and work effort only on the basis of prices and utility; in reality "economic man" is myopic, choosing to believe that what happened yesterday will happen forever -- until things change, and then *that* will happen forever. So we look at our situation, bemoan the fact that the great party that was the Eighties is over, and prepare to plunge into the end of civilization as we know it.

Well, all that may be fine for those who reached economic maturity in the past decade and thus have no real basis for comparison, but in reality the mess that opened the Eighties was far worse than anything we are likely to experience in the next year (Omigosh, he's starting another "Now, listen sonny, in my day..." lecture!).

At that time, the contraction rate of GNP had reached 6 percent, interest rates were forty percent higher than where they are now, and inflation was moving rapidly into double digits. Gasoline prices, that oft-used barometer of consumer well-being, were (in today's dollars) a little over $2 a gallon. I think we would be utterly shocked if anyone with the least pretension to respectability would suggest that these figures will be repeated in 1991.

But, in the world of economic life, everything is relative. After all, the Nixon Administration imposed a wage and price freeze on the economy in August 1971 because inflation had "skyrocketed" to *four* percent. Today, we would find nothing remarkable about that rate.

When we can recall growth of over three percent in the recent past, the third quarter number of 1.7 percent looks grim; unemployment of 6 percent is painful when 5 was the norm, and selling 3.3 million existing homes rather than 3.7 million is accounted as a bad year. This economic performance is nothing to write home about, but compare it to the recession of 1981-82, when the corresponding figures at the bottom were -2.5 percent for GNP, 9.7 percent for unemployment, and 2.0 million homes.

At that time we were facing a generally hostile OPEC, who was withholding oil production as a gambit to turn the West against Israel. Now the situation is very different. We have sent nearly a quarter million troops to Saudi Arabia to protect most of the Arab oil producers against Iraq. In gratitude, they are pumping oil at record rates. Barring a protracted shooting war, we can expect that oil prices will fall in the near future, a development that ought to bolster consumer confidence and offset recessionary momentum.

Another thing that's very different now is the role of the Federal Reserve in the economy. In 1980, the Fed had just shifted to a new way of targeting monetary policy that emphasized interest rates and growth rather than monetary aggregates. At the time, this looked like madness since rates were skyrocketing as fast as the economy was plunging. But this had to occur before the new policies would work, and it did and they did. The moderate inflation rates of the past seven years and the relatively mild fluctuations in interest rates are testimony to the wisdom of this change.

So in this slump of 1990, we have a monetary policy that is more sure of itself and therefore more able to use interest rates to bring back growth. We have seen recently the Fed move to lower interest rates and will likely see similar moves in the coming months. That will shorten this slowdown and lessen its severity.

The other major difference between 1980 and 1990 is the degree to which the world economy is interrelated. To most Americans, that means the Japanese buying Rockefeller Center or Universal Studios (No, folks, King Kong will not be replaced by Godzilla in Hollywood and Orlando). But it also means that recession will have little impact on the Midwest, because we sell more goods abroad, or on Florida, because we attract more and more foreign tourists.

The most interesting thing about the integration of the economies of the world is that the price system works. If the dollar falls in value, American goods are less expensive to foreigners; if there are no barriers to trading, that translates into effective demand. And so it is. The dollar has been falling in value in recent months, to levels hitherto unknown in many currencies. The result will be a continued growth in export production and thus a major offset to economic slowdown. In 1980, there was no similar mechanism to help out when other economic systems began to shut down.

The point here is not that the world is rosy. Even if we avoid technical recession (two consecutive quarters of contraction in real GNP), the weak growth that this economy has experienced in recent years ought not to be tolerated. But if history is any guide, we may well be viewing the prelude to yet another sustained spurt of economic growth.

Contrary to popular wisdom, history does not repeat itself. Rather, history is like a spiral: when it comes full circle, it's with a slightly different context. Some things are similar, but enough is different to require a real hard look. And that's what we need to do. It is best summed up by Joni Mitchell:

> *We're captive on a carousel of time.*
> *We can't return, we can only look*
> *Behind from where we came,*
> *And go round and round and round*
> *In the circle game.*

Outlook for the Economy and Real Estate

Last month was to have been the eighth anniversary of the longest peacetime expansion in U.S. history, but recent data has made any celebration moot. It's almost a sure bet that growth in the fourth quarter of 1990 will turn out to be negative, and it's widely believed that the following quarter will also show economic contraction. If so, then the usual definition of a recession would be satisfied: Two quarters of negative growth.

The recession, according to NAR's projections, will be relatively mild, with a decline only about one-third as deep as the average decline in the eight previous post-World War II recessions. A recovery is expected to take root by mid-year, making the two halves of the year dramatically different in terms of economic performance. The economy is projected to contract at a 1.0 percent rate during the first half but then expand at a 2.9 percent rate in the second half. Measured on a year-over-year basis, economic growth in 1991 will drop to a minuscule 0.1 percent but rebound to 2.8 percent in 1992.

Roots of the Recession

The major cause of the recession has been the Federal Reserve's tight monetary policies of the late 1980's. Designed to fight inflation by slowing economic growth, the Fed's "soft landing" approach raised short-term interest rates significantly in 1988. This led to the slowdown in growth that became evident in 1989 and brought the economy to the brink of recession by the late summer of 1990. Other forces have contributed as well, and chief among those was the credit crunch that evolved in response to the S&L crisis.

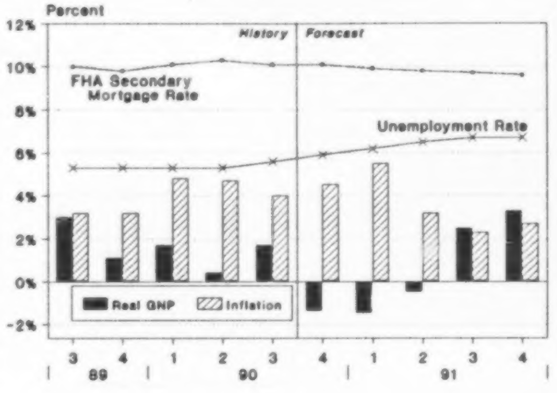
Then, in late July 1990, OPEC agreed to increase the price of oil by about 25 percent to $21 per barrel. Oil prices on the spot market moved upward after the announcement and surged days later when Iraq invaded Kuwait. The subsequent embargo of Iraqi and Kuwaiti oil and the threat of war kept oil prices high -- and, probably, pushed the U.S. economy into a recession. And as consumers read newspaper stories about the Gulf, they also saw that the government was ready to raise their taxes.

The Slowdown Becomes A Recession

Higher oil prices, higher taxes, and fears of war translated into a sharp drop-off in consumer confidence. October's plunge in the Conference Board's index was followed by further deterioration in November. This is being reflected at the cash registers, as retailers are reporting a slow holiday season so far. With disposable income and the savings rate falling, consumers are less willing to make big-ticket purchases: The annual sales rate of domestically-produced autos fell to 5.3 million units in late November, down from the year-to-date average of 6.9 million units.

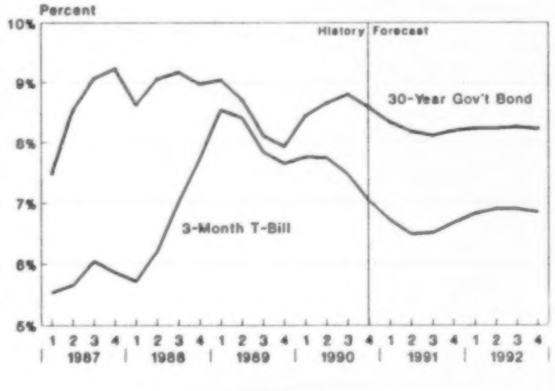
November's employment report, released in early December, shows the clearest sign that the soft landing has evolved into a recession. The graph at right shows that private nonfarm payrolls have been cut by almost half a million jobs in the past two months and that in only one month in 1990 did job growth exceed the average monthly gain during 1987-89. Construction payrolls fell for the sixth consecutive month, shedding 253,000 jobs -- with a quarter

The Economic Outlook



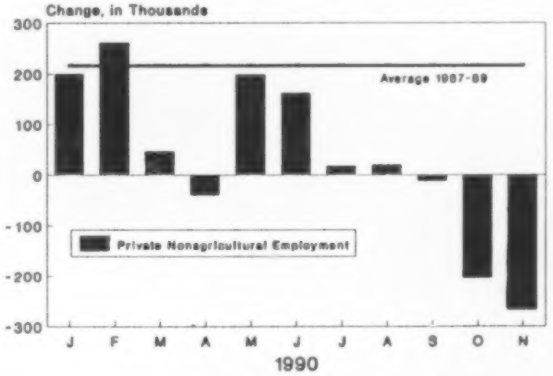
Sources: Bureau of Economic Analysis; NAR forecast

Interest Rates: Short and Long Term



Source: Federal Reserve Board, NAR forecast

Employment Reflects Weak Economy



Source: Bureau of Labor Statistics

of the losses coming in November alone. Manufacturing jobs, meanwhile, fell by another 200,000.

The Fed Eases

The Federal Reserve showed its concern over the economy's direction by cutting its target interest rate in the federal funds market to 7.25 percent from 7.5 precent in reaction to November's employment data. That makes for a three-quarter point cut since the end of October and suggests that the Fed has shifted some of its focus away from fighting inflation. In another counter to the credit crunch, the Fed lowered banks' reserve requirements, a move which allows banks to use more of their depositors' funds for making loans.

While the Fed appears more concerned about the recession than inflation, neither of these moves has sparked new fears of spiraling inflation. Inflation is expected to peak at 7.9 percent in the fourth quarter of 1990, as the economy continues to adjust to the fall's higher oil prices. During 1991, two factors will pull inflation down: the slack in the economy and the projected drop in oil prices.

In addition to inflation and recession, the Fed is also concerned with the weakness in the dollar. It's fallen about 16 percent in the past year, with almost half of the decline coming in the past four months. While this helps exports by making U.S. goods relatively less expensive, it also raises concerns among international investors about purchasing dollar-denominated assets, such as Treasury bonds, which fall in value as the dollar falls. To compensate themselves against this risk, investors may require higher returns -- keeping U.S. interest rates higher than they would be otherwise.

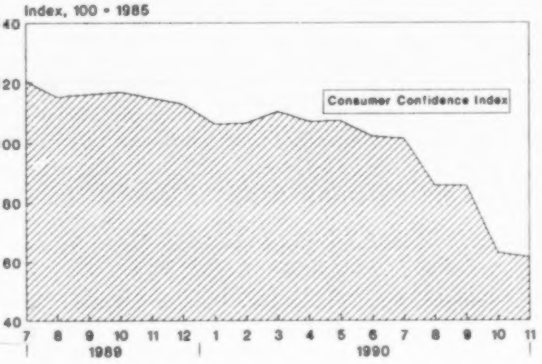
A Mild Recession in Sight

While most indicators are signalling recession, some are suggesting that the downturn will be mild. First, interest rates are falling. While the effect of the Fed's current easing may not be felt for months, at least interest rates were already headed in the right direction. In the five months prior to the start of the deep 1981-82 recession, short-term rates *rose* 1.6 percentage points, but in the five months before October 1990, short-term rates *fell* 0.4 percentage points.

Inventories are also lean, according to inventories-to-sales ratios. Since a drop in demand usually preceeds a cut in production, inventories usually rise abprutly before entering a recession. Businesses in turn order dramatic cuts in production to bring inventories down. But in this recession, the production cutbacks are expected to be relatively modest since the increase in inventories over the past two quarters was only $17 billion (in 1982 dollars). By comparison, in the two quarters prior to the 1981-82 recession, inventories rose by almost $50 billion.

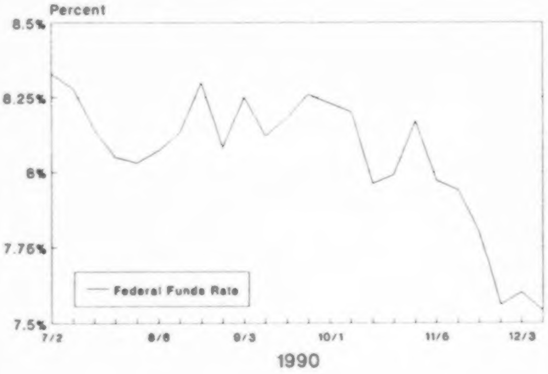
Finally, a diplomatic solution to the Persian Gulf crisis would remove the embargo and place severe downward pressure on the price of oil. This reversal in the oil shock would lead to improvement in inflation and an increase in household real income, contributing to economic growth by mid-1991. The forecast assumes a peaceful resolution and a subsequent decline in oil prices.

Consumer Confidence Erodes Further



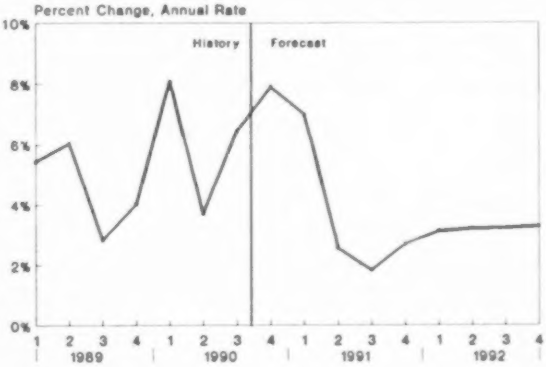
Source: The Conference Board

The Fed Fights a Weak Economy



Source: Federal Reserve Board

Pressure on Consumer Prices To Ease



Sources: Bureau of Labor Statistics, NAR forecast

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

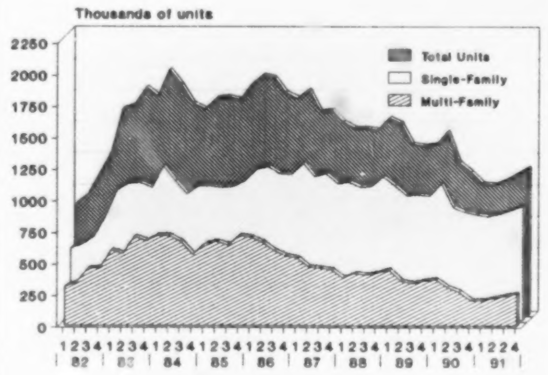
	Total	SF	2-4	5+
Oct 1989	1,423	1,023	60	340
Jun 1990	1,169	889	42	258
Jul 1990	1,153	875	29	249
Aug 1990	1,131	836	30	265
Sep 1990	1,107	863	34	210
Oct 1990	***1,041***	***854***	***31***	***156***
Annual Averages:				
1988	1,491	1,086	59	347
1989	1,386	1,010	55	321
Percent Changes in October 1990 since:				
Oct 1989	-26.8	-16.5	-48.3	-54.1
Sep 1990	-6.0	-1.0	-8.8	-25.7

Regional Data

	Northeast	Midwest	South	West
Oct 1989	174	285	567	397
Jun 1990	113	241	535	300
Jul 1990	113	225	493	322
Aug 1990	120	241	434	336
Sep 1990	104	242	441	320
Oct 1990	***144***	***236***	***395***	***266***
Annual Averages:				
1988	240	273	574	404
1989	183	270	536	397
Percent Changes in October 1990 since:				
Oct 1989	-17.2	-17.2	-30.3	-33.0
Sep 1990	38.5	-2.5	-10.4	-16.9

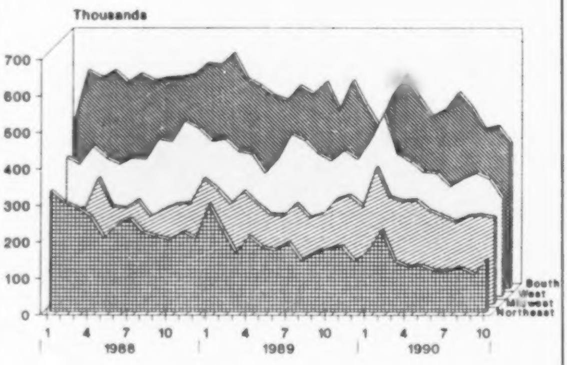
Source: Bureau of Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of Census

Housings starts dropped to an annual rate of 1,041,000 during October, marking the ninth consecutive month of decline. The pace is the lowest rate since the end of the last recession in October 1982. Relative to the first ten months of 1989, the pace of housing starts so far this year is down almost 12 percent. Single-family starts are down 8 percent; multi-family starts are down almost 21 percent.

Housing starts in the Northeast jumped in October to an annual rate of 144,000 units, up almost 40 percent from September's rate. In light of the weakening economy, it is doubtful that the region will be able to maintain this pace over the next six months. The other three regions experienced delcines in October.

Year-to-date figures show the divergent regional performances in housing starts. Relative to the same period in 1989, the pace of starts in the first ten months of 1990 dropped 27 percent in the Northeast, 12 percent in the West, and 11 percent in the South. The starts rate in the Midwest has held even with last year's pace.

Housing starts are not expected to reach bottom until the first quarter of 1991, when they are projected to average 1,043,000 units. A recovering economy and lower mortgage rates will spur home building in the second half of 1991. While starts are expected to post a 12 percent increase in 1992 -- numbering 1,220,000 units -- they will remain only four-fifths of 1988's activity.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

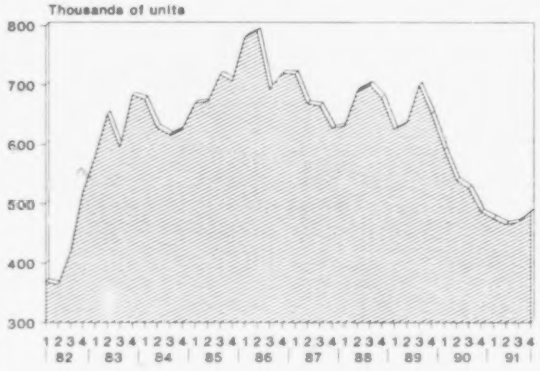
		Mo. Ago % Chg.	Yr. Ago % Chg.
Oct 1989	636	-0.3	-11.4
Nov 1989	687	8.0	5.7
Dec 1989	633	-7.9	-5.4
Jan 1990	613	-3.2	-12.9
Feb 1990	606	-1.1	-2.7
Mar 1990	558	-7.9	0.4
Apr 1990	533	-4.5	-12.6
May 1990	536	0.6	-17.7
Jun 1990	550	2.6	-14.9
Jul 1990	541	-1.6	-27.0
Aug 1990	530	-2.0	-26.3
Sep 1990	509	-4.0	-20.2
Oct 1990	***491***	***-3.5***	***-22.8***
Annual Averages:			
1988	676		0.8
1989	654		-3.3

Regional Data

	Northeast	Midwest	South	West
Oct 1989	88	101	271	176
Apr 1990	86	90	209	148
May 1990	71	91	215	159
Jun 1990	80	94	233	143
Jul 1990	70	93	238	140
Aug 1990	61	91	238	139
Sep 1990	57	94	221	137
Oct 1990	***84***	***83***	***212***	***112***
Annual Averages:				
1988	101	98	271	206
1989	90	103	258	202
Percent Changes in October 1990 since:				
Oct 1989	-4.5	-17.8	-21.8	-36.4
Sep 1990	47.4	-11.7	-4.1	-18.2

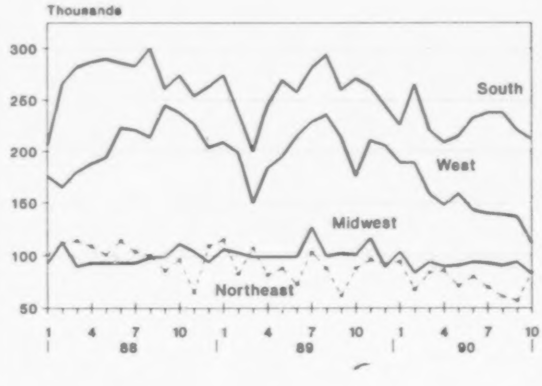
Source: Bureau of Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of Census

The new homes sales rate dipped below the half-million mark in October, when the annual pace fell 3.5 percent to 491,000 units. October also marks the fourth consecutive monthly decline and the ninth month in the past twelve that the sales rate has fallen. The rate is almost one-quarter below last October's sales rate.

The Northeast had a surprisingly strong October, according to the preliminary data. The sales rate jumped to 84,000 units, almost 50 percent higher than September's 57,000 unit rate. While the month was the strongest in the region since April, it remained 4.5 percent below the rate set in October 1989. The remaining three regions experienced declines in October, with the sharpest being an 18.2 percent decline in the West. The Midwest was off by 11.7 percent, and the South fell by 4.1 percent.

Sales of new homes are expected to average 487,000 in the final quarter of 1990, down 7.6 percent from the third quarter. With housing starts expected to continue its descent during the recession, sales of new homes will also be falling. The bottom will be reached in the second quarter of 1991, when the sales rate is expected to reach 466,000 units. The recession will send mortgage rates down and, by the second half of 1991, the economic recovery will foster an increase in demand for new homes. It is possible that the buying opportunities afforded by lower mortgage rates and rising incomes in late 1991 and into 1992 may catch home builders short of supply.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

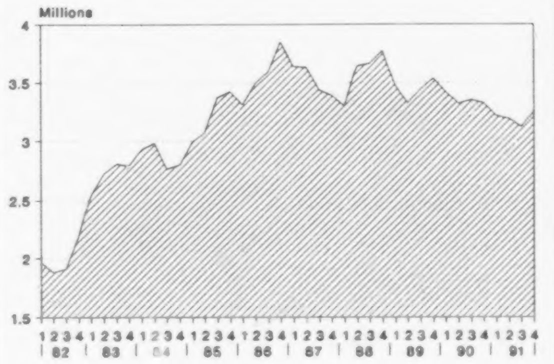
		Mo. Ago % Chg.	Yr. Ago % Chg.
Oct 1989	3,490	-0.6	-5.2
Nov 1989	3,560	2.0	-4.0
Dec 1989	3,560	0.0	-9.2
Jan 1990	3,470	-2.5	-5.2
Feb 1990	3,400	-2.0	-4.2
Mar 1990	3,400	0.0	-0.9
Apr 1990	3,330	-2.1	-3.2
May 1990	3,300	-0.9	1.5
Jun 1990	3,330	0.9	0.0
Jul 1990	3,330	0.0	-1.5
Aug 1990	3,500	5.1	1.7
Sep 1990	3,170	-9.4	-9.7
Oct 1990	***3,020***	***-4.7***	***-13.5***
Annual Averages:			
1988	3,594		-1.9
1989	3,467		-3.6

Regional Data

	Northeast	Midwest	South	West
Oct 1989	610	970	1,300	610
May 1990	520	880	1,320	570
Jun 1990	490	960	1,310	580
Jul 1990	560	930	1,310	530
Aug 1990	520	990	1,400	570
Sep 1990	520	870	1,260	520
Oct 1990	***470***	***820***	***1,230***	***490***
Annual Averages:				
1988	669	929	1,348	643
1989	590	931	1,320	617
Percent changes in October 1990 since:				
Oct 1989	-23.0	-15.5	-5.4	-19.7
Sep 1990	-9.6	-5.7	-2.4	-5.8

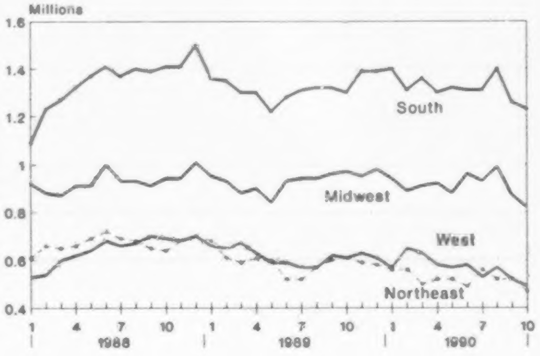
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

The deteriorating economy caused existing home sales to decline 4.7 percent to their lowest level in nearly six years. In the two months since posting a sizable gain in August, sales dropped by a cumulative 13.7 percent to stand at an annual rate of 3,020,000 units.

On a year-to-date basis, sales have slipped 3.6 percent in 1990 relative to 1989. The declines have been the most severe in the Northeast and the West, which are off 11.7 percent and 7.6 percent, respectively, in the year's first ten months. The Midwest has dropped 1.4 percent, and the South's sales pace has risen 1.1 percent.

The more recent performance is more ominous, however, suggesting that the declines on the coasts have spread to the rest of the nation. In contrast to modest gain noted above so far in 1990, the sales pace in the South fell 12.1 percent from August to October. The Midwest has experienced the sharpest fall, 17.2 percent, over the two months. The West dropped 14 percent and the Northeast slipped 9.6 percent. These declines correspond, of course, with the sharply increased fear of recession that came in the wake of the eruption of the Persian Gulf crisis.

The fourth quarter of 1990 is expected to be the low point for existing home sales, with marginal improvements made in the following two quarters. The rebound in the economy and lower interest rates will push existing home sales up in the last half of 1991. Sales are projected to be down 3.0 percent in 1991 but up 7.2 percent in 1992.

Single-Family Home Prices

(In Dollars)

National Data

	Median Existing	Median New	Average Existing	Average New
Oct 1989	92,400	123,000	116,700	147,800
May 1990	95,600	125,000	118,700	150,600
Jun 1990	97,500	125,000	121,100	150,400
Jul 1990	98,300	118,700	122,000	149,800
Aug 1990	97,100	118,500	120,500	145,300
Sep 1990	94,400	112,900	116,700	143,400
Oct 1990	***92,800***	***121,800***	***115,700***	***157,500***
Annual Averages:				
1988	89,200	113,400	112,500	138,900
1989	92,900	120,400	118,000	148,300
Percent changes in October 1990 since:				
Oct 1989	0.4	-1.0	-0.9	6.6
Sep 1990	-1.7	7.9	-0.9	9.8

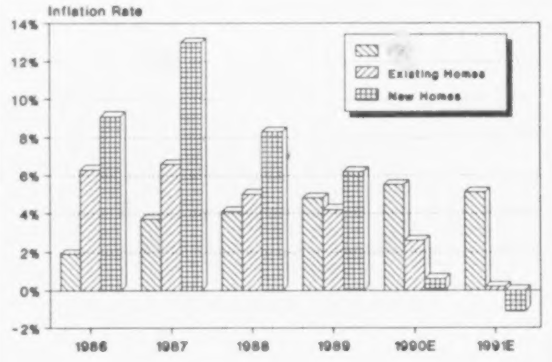
Regional Data

Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Oct 1989	143,200	71,600	83,600	140,300
May 1990	141,300	73,500	85,100	141,800
Jun 1990	148,300	75,900	87,500	138,100
Jul 1990	146,900	76,000	88,800	139,700
Aug 1990	145,300	75,300	86,900	140,200
Sep 1990	137,100	74,200	85,900	134,700
Oct 1990	***136,200***	***72,100***	***83,400***	***140,600***
Annual Averages:				
1988	142,500	68,200	82,200	124,700
1989	145,100	71,200	84,400	139,800
Percent changes in October 1990 since:				
Oct 1989	-4.9	0.7	-0.2	0.2
Sep 1990	-0.7	-2.8	-2.9	4.4

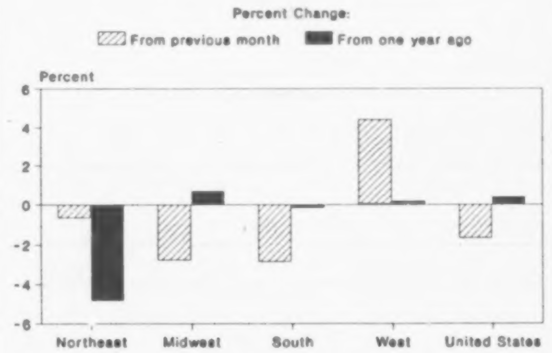
Source: National Association of Realtors,® "Home Sales"

Home Prices



Source: Bureau of Census; E Real Estate Outlook forecast

Home Prices by Region



Source: NAR Economics & Research; Real Estate Outlook forecast

Median prices of existing homes fell by 1.7 percent in October to $92,800, $1,600 below September's level. Although the October figure is about 6 percent below July's peak, it remains higher than the median price in October 1989. The median price for new homes, on the other hand, jumped $8,900, or 7.9 percent, in October to stand at $121,800. The rebound comes after the median price for new homes had dropped $12,100, or 9.7 percent, between June and September. Relative to its level of a year ago, the median price is down by 1.0 percent.

The higher prices for new homes is also reflected in measures of average prices. In October, the average new home price gained $14,100, or 9.8 percent, to stand at $157,500. Given the market conditions and the sluggishness of the new homes market (see page 5), this suggests that the composition of new homes sold may have shifted to more expensive homes rather than price increases on individual homes.

The unequal regional difficulties in housing markets is reflected in the median prices for existing homes. Relative to October 1989, prices in the Midwest, the South and the West show basically no change, but prices in the Northeast have dropped 4.9 percent.

Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis Division

THE 1991 BUDGET AND HOUSING BILL: A RENEWED COMMITMENT

Congress and the Administration have shaken hands, albeit reluctantly, on a long-awaited budget resolution. The final Omnibus Budget Reconciliation Act of 1990, which is a hodgepodge of spending cuts, revenue enhancements, program reforms and rules for greater oversight, is designed to slice $500 billion from the burgeoning federal budget deficit over a five-year period, and $40 billion in 1991 alone.

Getting there wasn't easy though -- the road to the budget agreement was a long and winding one. The journey began on January 29 when President Bush submitted his $1.23 trillion spending plan to Congress. Negotiations between Congress and the Administration formally began on May 9. And it was in early November when major newspapers across the country heralded the arrival of a budget agreement.

The 1991 Budget agreement and housing legislation is, in many respects, a renewal of federal commitment to housing. This federal commitment to housing flows through two primary channels: 1) increased funding for existing programs and new programs under the Cranston-Gonzalez National Affordable Housing Act, and 2) extensions of several of the tax incentive programs. This article [illegible] looks at the National Affordable Housing Act [illegible] then turns to the tax incentive programs for housing.

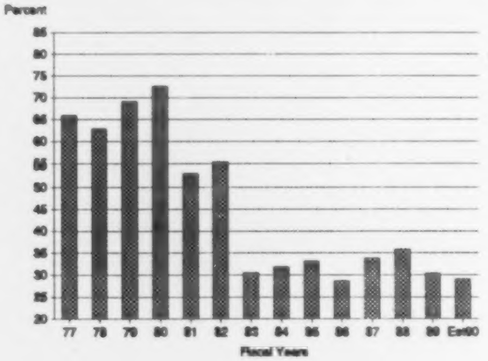
NATIONAL AFFORDABLE HOUSING ACT

President Bush recently signed a two-year $57.4 billion housing bill. The bill provides funding for some of the existing housing assistance programs, includes measures to aid the financially faltering Federal Housing Administration, and funds some of U.S. Department of Housing and Urban Development (HUD) Secretary Jack Kemp's HOPE proposals. Funding within the housing bill includes increases of $273 million for Community Development Grants; $1.8 billion for assisted housing; $6.7 billion for renewal of expiring federal contracts; and $235 million for operating subsidies for low-income housing.

Table 1 shows that from 1977 to 1982, rental commitments through production programs -- which include Section 8 new construction and substantial rehabilitation, public housing, and Farmers Home Administration Section 515 programs -- ranged from 53 percent to 73 percent of all new rental commitments. Since 1982, additional rental commitments for these programs have been only about one-third of the total.

Net new rental commitments are the number of housing units for which funds are appropriated in a given year. This does not necessarily mean that the units are constructed within the appropriation year, only that the money to do so has been committed. These numbers take into account units for which funds are deobligated or cancelled that year, as well as units replacing those lost because private owners of assisted housing opted out of programs or because public housing units were demolished.

Table 1
NET NEW FEDERAL COMMITMENTS FOR RENTERS THROUGH NEW PRODUCTION
(as percent of total net-new commitments for renters)



SOURCE: Congressional Budget Office based on data provided by the HUD and Farmers Home Administration.

In an important change of policy, the legislation resumes federal support for new production of affordable housing. Local and state governments may now use a $3.1 billion line of credit provided by HUD on a range of housing projects including housing rehabilitation, new construction, and tenant acquisition of public units.

Federal Housing Administration (FHA) and Secondary Mortgage Markets

For mortgage programs, Congress authorized a $76.8 billion limit on Federal Housing Administration (FHA)-insured mortgages for fiscal year (FY) 1991 (and $79.8 billion for FY 1992.) To date, actual appropriations for FY 1991 are $75 billion, an increase of $8.0 billion over the 1990 appropriation.

Congress also authorized an $84.9 billion ceiling on Government National Mortgage Association (GNMA)-guaranteed mortgage-backed securities for FY 1991 (and $88.3 billion for FY 1992.) To date, actual appropriations for FY 1991 are $80 billion -- representing an increase of $5.0 billion over the 1990 appropriation.

A 1989 appropriations bill temporarily raised the ceiling on the FHA loan amount for high-cost areas from 150 percent to 185 percent of the base limit of $67,500 ($101,250 to $124,875). The National Affordable Housing Act establishes the $124,875 ceiling until further modifications.

The changes to the FHA mortgage insurance program increase the equity stake required of FHA home buyers to reduce risk to the Mutual Mortgage Insurance (MMI) Fund. This new legislation generally increases the upfront costs which must be borne by homeowners by restricting the allowed FHA loan amount (before mortgage insurance premium). The mortgage may not involve a principal obligation in excess of 98.75 percent of the appraised value of the property (97.75 percent, in the case of a mortgage on a property with an appraised value in excess of $50,000), plus the amount of the mortgage insurance premium paid at the time the mortgage is insured.

Home buyers are required to pay a risk-based premium of 0.5 percent of their loan balance for a specified number of years depending on the loan-to-value (LTV). That is, home buyers who can lower their LTVs by making larger down payments will pay the premium for a shorter period.

Under these changes, the government is expected to save approximately $3.4 billion over five years. However, as noted earlier, these changes will increase the cost of using FHA-mortgages. For a typical FHA-insured home of $65,000, home buyers will have to put up approximately $564 more. The Center on Budget and Policy Priorities reports in its November publication, One Step Forward, that between 35,000 and 100,000 fewer households will be able to participate in FHA-insured mortgages each year due to the changes.

National Homeownership Trust Demonstration (NHT)

The housing legislation established a National Homeownership Trust Demonstration designed to provide assistance to first-time home buyers. Congress has authorized $250 million for FY 1991 and $521.5 million for FY 1992.

To qualify for this assistance, the home buyer's income for the previous year cannot exceed 95 percent of the median area income for a family of four, or 115 percent of median area income in designated FHA high-cost mortgage areas. These limits will be adjusted for family size. The property must be a single-family residence or co-op unit that is intended as the buyer's principal residence and the mortgage amount cannot exceed the FHA limit.

NHT assists first-time home buyers in two ways. First, NHT can buydown the effective mortgage rate such that it does not exceed six percent. Second, NHT can assist with down payment and closing costs, provided that the home buyer pays at least one percent of the cost of acquisition (excluding any upfront mortgage insurance premium). NHT funding is secured by a lien on the property.

Recipients of NHT assistance must continue to meet the conditions of the program or NHT can request the repayment of assistance. An example of a condition under which NHT can request repayment is an appreciable increase in the recipient's income for a sustained period of time. That is, if family income exceeds the program limit for a two-year period, then NHT can request repayment, even if the family is still living in the home.

Homeownership and Opportunity for People Everywhere (HOPE) and HOME Investment Partnerships Act Programs

The programs of HOPE and HOME are designed to promote the expansion of housing opportunities to low- and moderate-income households. While the purpose of HOPE is primarily to encourage homeownership among such households, HOME is designed to increase investment in affordable rental housing, primarily through the rehabilitation of existing structures.

To these ends, $1 billion has been authorized for HOPE programs over two years.

The three categories of homeownership programs are HOPE for Public and Indian Housing Homeownership; HOPE for Homeownership of Multifamily Units; HOPE for Homeownership of Single Family Homes. While the specifics of the three categories of programs differ, the bottom line is the same -- the encouragement of homeownership among low-income families.

The essential elements for public and Indian housing include the following. HUD will grant money to certain entities, such as non-profit organizations and resident management corporations, for tenants of public and Indian housing to acquire ownership of their homes. The tenants must acquire ownership interest in at least one-half of the project units, and the purchase price cannot exceed 30 percent of the tenant's adjusted monthly income. Twenty-five percent of HUD assistance must be matched by nonfederal sources.

In return for the assistance, the proceeds from sale which the recipient can retain are limited. If the property is sold within the first six years, the amount received by the homeowner will be limited to the homeowner's initial contribution, value of any improvements paid by the seller and an inflation adjustment. For resales between six and twenty years, HUD or the homeownership program will recapture the difference between the initial purchase price and the market value at the time of purchase. Stated otherwise, HUD will recapture the assistance. The sale proceeds which are not retained by the seller are split 50-50 between HUD and the organization that originally sold the units to the seller.

The elements of HOPE programs for multifamily and single-family units are similar to that of public and Indian housing. The only major differences are higher matching requirements for both multifamily and single-family (33 percent for both types compared to 25 percent for public and Indian housing), and greater ownership interest required (100 percent for multifamily versus 50 percent for public and Indian housing.)

HOME received funding of $1 billion for FY 1991 and $2.1 billion for FY 1992. Sixty percent of these funds will go to local governments and 40 percent will go to the states, with a minimum allocation for a state at $3 million and $500,000 for a locality. At least 90 percent of funding must be allocated to units occupied by persons with incomes at or below 60 percent of the area's median income; the remainder, if any, can serve the needs of families with somewhat higher incomes, but the incomes must be at or below 80 percent of the area's median income.

HUD will make HOME funds available to participating jurisdictions through the establishment of HOME Trust Funds. Jurisdictions in turn can make HOME funds available to private parties or government agencies in the form of equity investments, and interest-bearing or non-interest-bearing loans.

HOME funds can be used for acquisition, construction, reconstruction, and rehabilitation of affordable rental and ownership housing, with preference given for rehabilitation. If, however, the participating jurisdiction determines that rehab is not the most cost-effective way to meet the housing needs; if there is an inadequate supply of housing with rents below Section 8 Fair Market Rents; or if there is a shortage of substandard housing suitable for rehabilitation, this preference will be waived.

Each participating jurisdiction must contribute an amount equal to at least 25 percent of HOME funds used for rental assistance and rehab, 33 percent of funds for substantial rehabilitation, and 50 percent of funds for new construction. This matching assistance may be in the form of cash, land, or other in-kind contributions.

Low-Income Housing Preservation and Resident Homeownership Act of 1990

The Emergency Low-Income Housing Preservation Act of 1987 was a stop-gap measure enacted by Congress to halt the loss of affordable housing. Rewritten and renamed, the Low-Income Housing Preservation and Resident Homeownership Act of 1990 provides a more lasting solution by offering fair market incentives to owners. The Act provides owners with fair market value incentives to retain the project as low-income housing or fair market price to sell the project to a buyer willing to maintain it as low-income housing. The owner would be permitted to prepay the mortgage under restrictive conditions, including the inability to find a willing and able buyer.

U.S. Department of Veterans Affairs Loan Guaranty Program

While not technically part of the National Affordable Housing Act, alterations to the VA home loan-guaranty program affect potential home buyers and, as such, deserve mention here. The funding fee for borrowers acquiring mortgages guaranteed by the Department of Veterans Affairs will be raised by 0.625 percentage points (1.25 to 1.875). This is slightly higher than the 0.50 percentage point increase originally proposed by President Bush. The funding fee is used to offset program operating costs, including default payments which have been particularly high in recent years. Borrowers may finance the fee as part of their mortgages, making the mortgage payment up to $2.00 a month higher.

The budget maintains the "sliding scale" adjustment for borrowers making down payments of five percent or more. VA-borrowers who make down payments of five percent to slightly less than 10 percent will now pay a 1.375 percent fee, while those making down payments of 10 percent or greater will pay 1.125 percent. Borrowers who refinance loans also pay the 1.875 percent funding fee regardless of the amount of equity in their properties. The fee increases are expected to add $79 million to the federal government's coffer over the next five years.

TAX INCENTIVES FOR HOUSING

Along with the federal housing programs contained in the National Affordable Housing Act, tax incentives also have a substantial impact on such housing activities as the construction of affordable housing and the investment in housing through homeownership.

Low-Income Housing Tax Credit

The budget extends, through 1991, the low-income housing tax credit. This tax incentive encourages private sector construction and rehabilitation of housing affordable to the working poor and other low-income families. The Joint Committee on Taxation estimates the cost of extending the low-income housing tax credit through December 31, 1991 to be around $200 million.

Under the budget, the credit allocation authority for each state in 1991 is set at a level of $1.25 per resident. And the new budget bill requires that 10 percent of the state's annual tax credit authority be set aside for projects involving qualified non-profit organizations. The law also clarifies that states are allowed to "carry over", for use in the following year, any unused tax credit authority and returned credits from the current calendar year.

Expenditures eligible for the credit remain substantially unaltered. They include the depreciable costs of new construction and substantial rehabilitation and the acquisition costs of certain buildings neither placed in service nor substantially rehabilitated during the prior 10 years.

In return for the credit, the building owner must continue to operate the project as low-income housing over an initial 15-year compliance period. An extended use period, established in 1989, is an additional period of no less than 15 years over which the owner must continue to maintain the project as low-cost. This extended use period can be terminated under select conditions. By law, an owner wanting to convert or sell a low-income building after the initial 15 years must first give the state housing credit agency one year to find a qualified buyer willing to purchase the low-income units for a restricted sales price and to maintain them as low-income rentals for the remainder of the extended use period. In the event that no buyer can be found, the owner is free to convert or sell to anyone at any price, thereby ending the extended use period.[1] In the event of a sale or conversion, the current owner may not evict any current occupants of low-income units without good cause nor increase the gross rents for their units for three years, except under select conditions. (Gross rent is contract rent plus a utility allowance. If the owner pays utilities, then the utility allowance is $0.)

The program's link between rents and area median income constitutes the basis for one such condition. An owner receiving the credit is required to reserve either 20 percent of units in his project for families earning at or below 50 percent of the area median income or 40 percent of units for families earning at or below 60 percent of the area median income. For units reserved for families earning at or below 50 percent of the area median income, the maximum rent that the owner is allowed to charge is 30 percent of 50 percent of the area median income. If the area median income is $25,000, then the owner is allowed to charge $3,750 a year ($25,000 x .5 x .3) or $312.50 a month.

If inflation pushes the area median income to $30,000, then the maximum amount an owner is allowed to charge on units occupied by tenants earning at or below 50 percent of the area median increases to $4,500 a year ($30,000 x .5 x .3), or $375 a month. (Rents for units reserved for families earning at or below 60 percent of the area median income are similarly calculated.)

Mortgage Revenue Bond Program

Mortgage revenue bond (MRB) programs administered through State Housing Finance Agencies and local agencies have been important sources in financing home purchases to first-time buyers. The savings to investors in MRBs, which derive from tax-exempt interest earnings on the bonds, can be passed forward to mortgage borrowers in the form of below-market interest rates. It is estimated that state and local housing agencies assisted several hundred thousand first-time home buyers through the more than $50 billion in tax-exempt qualified mortgage bonds they issued between 1982 and 1986. The budget extends the authority of states (and localities) to issue MRBs through 1991. The Joint Committee on Taxation estimates the 1991-1995 cumulative cost of extending this program through December 31, 1991 to be $400 million, or roughly $800,000 a year.

The new budget maintains the limit on tax-exempt financing for private activities, including financing home purchases and multifamily construction, established by the Tax Reform Act of 1986. Each state's "unified volume cap" remains at the greater of $50 per resident of the state or $150 million.

The most significant change to the MRB program affects the recapture rules. The rationale behind the recapture requirements is that households buying homes with bond-financed mortgages should repay a portion of the subsidy if they resell their homes within a certain period and their income has risen appreciably.

Under the original recapture rules, the amount of the recapture tax increased gradually until the end of the fifth year and then declined until the end of the tenth year, when the tax fell to zero.

The new law reduces the maximum recapture period from ten to nine years, adjusts the recapture amount annually rather than monthly, and liberalizes the rules exempting homeowners with inconsequential income increases from recapture.

The recapture amount is equal to the lesser of (1) 50 percent of the gain from the disposition of the home; or (2) the product of the applicable "holding period" percentage, the imputed mortgage bond subsidy (6.25 percent of the highest principal loan balance) and an income percentage. (The specification of the highest principal loan balance as opposed to just the initial principal loan balance is necessary because there is no provision in the MRB program which prohibits negative amortization of the principal balance.)

The holding period percentage is designed to decrease the recapture tax for households remaining in their homes for longer periods. The percentages are as follows:

	Holding Period Percentage					
	0%	20%	40%	60%	80%	100%
Year of Property Dis-position		1	2	3	4	5
	10	9	8	7	6	

The purpose of the "income percentage," whose calculation is complicated and will not be discussed here, is to assess whether a recipient of a bond-finance mortgage has had a substantial increase in income between the year of loan origination and the year of the property disposition. The smaller the increase in income, the lower the "income percentage" and therefore the lower the recapture tax.

Mortgage Interest Deduction

The new budget maintains the principal amount on which taxpayers may deduct mortgage interest at $1,100,000 but limits the total itemized deductions which high-income taxpayers are allowed to take. Under the new budget, allowable tax deductions will be reduced by three percent, or $300, for every $10,000 of adjusted gross income in excess of $100,000 for single and joint filers and $50,000 for married taxpayers filing separately. In no event, however, may more than 80 percent of the otherwise allowable deductions be disallowed. The income thresholds will be adjusted for inflation beginning in 1991.

While mortgage interest is one of the largest exemptions that many itemizing taxpayers claim, it is important to note that taxpayers claiming the mortgage interest deduction are not "penalized" relative to other taxpayers with the same income but who do not claim the mortgage interest deduction. The reason is that the amount of deductions disallowed does not increase for higher amounts or different types of itemized deductions. The disallowed amount depends only on income. The example in Table 2 illustrates how the limitation works.

Table 2
ILLUSTRATION OF DISALLOWANCE OF ITEMIZED DEDUCTIONS

	Taxpayer without Mortgage	Taxpayer with Mortgage
Income	$200,000	$200,000
Personal Exemptions family of 4a/	-$8,200	-$8,200
Itemized Deductions	-$30,000	-$40,000

It is assumed that the itemized deductions for the taxpayer with the mortgage are $10,000 higher than the itemized deductions of the taxpayer without the mortgage.

"Disallowed" amount 200,000 - 100,000 x 0.03 =	$3,000	$3,000

The disallowed amounts are the same because the amount does not depend on the type or amount of itemized deductions.

Taxable Income	$164,800	$154,800

Taxable income is $10,000 lower for the taxpayer with the mortgage. While the taxable incomes for both taxpayers would be lower in the absence of the "disallowance" – $161,800 for the taxpayer without a mortgage – $151,800 for the taxpayer with a mortgage, the $10,000 difference between the taxable incomes of the two taxpayers remains the same.

a/ This example disregards the new phase-out of the tax benefit from personal exemptions. This is not relevant for this example.

Source: House Budget Committee, Leon E. Panetta, Chairman, "Fiscal Year 1991 Budget Agreement, Summary Materials," October 27, 1990, p.30.

HOW WILL HOUSEHOLDS FARE?

Households on all rungs of the economic ladder will be affected by the new budget and housing legislation.

Low- and moderate-income households are the target of the myriad HOPE programs. They also will benefit from new investment in affordable housing encouraged by the Low-Income Housing Tax Credit. Finally, the Low-Income Housing Preservation and Resident Homeownership Act of 1990 provides owners of federally-assisted housing with fair market incentives to maintain their buildings as low-income housing, thereby minimizing displacement of tenants as contracts expire.

Middle-income households will be hurt by some elements of the bill and helped by others. The permanent increase in the FHA loan limit will enable first-time home buyers in high-cost areas to use FHA mortgages. At the same time, risk-based premiums on FHA loans and the restrictions on the FHA loan amount could increase both the upfront and annual costs of homeownership. Some prospective first-time home buyers will be assisted by the National Homeownership Trust, which will provide down payment assistance and below-market interest rate mortgages for eligible households. The continuation of the mortgage revenue bond program will further increase the availability of below-market interest rate mortgages.

High-income homeowners will be affected by the limitation on the income tax deductions they are allowed to take. It is important to remember however that the limitations are based on their incomes, not the amount of their deductions. So the amount of disallowed deductions will be the same for taxpayers with the same incomes, regardless of whether or not they have mortgage debt on their residences.

by
Mary B. Schwartz
Housing Economist
Housing Research

Lorraine Voss
Research Assistant
Housing Research

---

[1] There are a few other conditions under which

the extended use period may be terminated. For a detailed account, see article in November 12, 1990 Housing and Development Reporter, "Low-Income Housing Tax Credit Extended, Revised by Budget Bill."

References

"Low-Income Housing Tax Credit Extended, Revised by Budget Bill," Housing and Development Reporter (Boston, Massachusetts: Warren, Gorham and Lamont, November 12, 1990), pp. 546-48.

"Budget Law Extends Mortgage Bonds, Revises Recapture, Raises VA Loan Fee," Housing and Development Reporter (Boston, Massachusetts: Warren, Gorham and Lamont, November 12, 1990) pp. 548-50.

"Summary of Cranston-Gonzalez National Affordable Housing Act," Housing and Development Reporter (Boston, Massachusetts: Warren, Gorham and Lamont, November 12, 1990), pp. 580-608.

Joint Committee on Taxation, report to Senate Finance Committee, "Budget Reconciliation - Revenue Proposals," October 12, 1990.

Leonard, Paul and Robert Greenstein. One Step Forward-The Deficit Reduction Package of 1990 (Washington, D.C.: Center on Budget and Policy Priorities, November 1990).

Panetta, Leon E. "Fiscal Year 1991 Budget Agreement Summary Materials," House Budget Committee, October 27, 1990.

Pedone, Carla I. Current Housing Problems and Possible Federal Responses (Washington, D.C.: U.S. Government Printing Office, 1988).

Wrightson, Margaret. Who Benefits From Single-Family Housing Bonds?: History, Development and Common Experience of State Administered Mortgage Revenue Bond Programs (Washington, D.C.: Georgetown University, 1988).

Zimmerman, Dennis. The Volume Cap for Tax Exempt Private Activity Bonds: State and Local Experience in 1989 (Washington, D.C.: The Advisory Commission on Intergovernmental Relations, 1990).

U.S. Economic Outlook: December 1990

Quarterly figures are seasonally adjusted annual rates

	90.2	90.3	90.4	91.1	91.2	91.3	91.4	92.1	1988	1989	1990	1991	1992
U.S. Economy													
Annual Growth Rate													
Real GNP	0.4	1.7	-1.4	-1.5	-0.5	2.5	3.3	3.2	4.5	2.5	1.0	0.1	2.8
Industrial Production	4.3	3.7	-3.7	-0.8	-1.4	2.6	3.7	3.3	5.4	2.6	1.2	0.1	3.1
Civilian Employment	0.7	-1.5	-1.1	-0.6	-0.7	0.1	0.9	1.3	2.3	2.0	0.5	-0.6	1.1
GNP Inflation Index	4.7	4.0	4.5	5.5	3.2	2.3	2.7	3.1	3.3	4.1	4.2	4.1	2.7
Consumer Prices	3.7	6.4	7.9	7.0	2.6	1.8	2.7	3.1	4.1	4.8	5.5	5.1	2.9
Value of the U.S. Dollar	-2.0	-20.7	-21.7	-5.6	1.0	5.2	1.0	-1.2	-4.3	6.2	-9.8	-8.0	0.4
Percent													
Mfg. Capacity Utilization	82.8	82.7	81.5	81.3	80.7	80.9	81.4	81.7	83.9	83.9	82.4	81.1	82.4
Civilian Unemployment	5.3	5.6	5.9	6.2	6.5	6.7	6.7	6.6	5.5	5.3	5.5	6.5	6.4
Percent of GNP													
Federal Tax Receipts	20.3	20.4	20.5	20.6	20.4	20.4	20.5	20.7	20.0	20.2	20.3	20.5	20.7
Federal Expenditures	23.4	23.0	23.3	23.5	23.5	23.5	23.3	23.4	22.9	22.8	23.2	23.4	23.1
Federal Budget Deficit	-3.0	-2.6	-2.7	-2.9	-3.1	-3.0	-2.8	-2.6	-2.9	-2.6	-2.9	-2.9	-2.4
Interest Rates, Percent													
Federal Funds Rate	8.2	8.2	7.7	7.4	7.1	7.1	7.3	7.5	7.6	9.2	8.1	7.2	7.6
3-Month T-Bill Rate	7.7	7.5	7.0	6.7	6.5	6.5	6.7	6.8	6.7	8.1	7.5	6.6	6.9
Prime Rate	10.0	10.0	9.9	9.8	9.5	9.4	9.6	9.7	9.3	10.9	10.0	9.6	9.7
Discount Rate	7.0	7.0	7.0	6.7	6.4	6.2	6.3	6.4	6.2	6.9	7.0	6.4	6.5
Corporate AAA Bond Yield	9.4	9.4	9.3	9.0	8.9	8.8	8.9	8.9	9.7	9.3	9.3	8.9	8.9
30-Year Government Bond Yield	8.7	8.8	8.6	8.3	8.2	8.1	8.2	8.2	9.0	8.4	8.6	8.2	8.2
Mortgage Rates, Percent													
30-Year Fixed Rate	10.3	10.1	10.0	9.7	9.5	9.5	9.6	9.6	10.3	10.3	10.1	9.6	9.6
1-Year Adjustable	8.6	8.4	8.2	8.1	8.0	8.0	8.0	8.1	8.5	9.3	8.3	8.0	8.1
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	4,188	4,166	3,905	3,917	3,955	4,060	4,181	4,266	4,648	4,446	4,183	4,028	4,326
Existing Single-Family Sales	3,320	3,333	3,090	3,117	3,139	3,211	3,302	3,366	3,594	3,467	3,292	3,192	3,422
New Single-Family Sales	540	527	487	476	466	470	488	501	676	654	536	475	512
Housing Starts	1,204	1,130	1,043	1,030	1,065	1,116	1,165	1,201	1,491	1,386	1,208	1,094	1,220
Single-Family Units	895	858	840	825	842	875	906	927	1,086	1,010	919	862	932
Multi-Family Units	309	272	203	205	223	241	259	274	405	377	289	232	288
2-4 Family Units	44	31	23	23	25	27	29	31	59	55	35	26	33
5+ Family Units	265	241	180	181	198	214	229	242	347	321	254	206	255
Mobile Homes Shipped	190	187	191	187	187	193	200	202	218	199	191	192	203
Percent change – Year Ago													
Total Single-Family Sales	-2.7	-5.5	-13.1	-12.4	-5.6	-2.5	7.1	8.9	0.4	-4.3	-5.9	-3.7	7.4
Existing Single-Family Sales	-0.6	-3.2	-12.6	-8.9	-5.5	-3.7	6.9	8.0	2.4	-3.6	-5.1	-3.0	7.2
New Single-Family Sales	-15.1	-24.7	-25.3	-19.7	-13.7	-10.7	0.2	5.4	0.8	-3.3	-17.9	-11.5	7.8
Housing Starts	-1.1	-15.5	-22.6	-29.2	-11.5	-1.2	11.7	16.6	-8.6	-7.0	-12.9	-9.4	11.5
Single-Family Units	-1.0	-13.8	-15.0	-23.8	-5.9	2.0	7.9	12.4	-5.9	-7.0	-9.0	-6.2	8.1
Multi-Family Units	-1.5	-20.4	-43.6	-44.9	-27.7	-11.4	27.7	33.7	-14.9	-7.1	-23.3	-19.7	23.9
2-4 Family Units	-1.8	-44.6	-56.7	-46.2	-41.7	-11.4	27.7	33.7	-10.0	-5.7	-36.4	-25.1	23.9
5+ Family Units	-1.4	-15.7	-41.3	-44.7	-25.4	-11.4	27.7	33.7	-15.7	-7.3	-21.0	-18.9	23.9
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.2	96.6	92.8	93.1	95.2	96.1	97.8	99.0	89.2	92.9	95.4	95.6	100.7
New Home Prices	126.7	116.7	117.8	118.1	119.2	120.2	121.7	124.3	113.4	120.4	121.1	119.8	126.5
Percent Change - Year Ago													
Existing Home Prices	3.5	1.7	0.1	-3.0	-1.0	-0.5	5.4	6.3	5.0	4.2	2.6	0.2	5.3
New Home Prices	6.0	-2.5	-5.3	-4.1	-5.9	3.0	3.3	5.2	8.3	6.2	0.6	-1.1	5.6

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kim Martin.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

REALTOR®

EQUAL HOUSING
OPPORTUNITY

A700 [illegible]

REAL ESTATE OUTLOOK

Vol. 4, No. 1

January 1991

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The nation's economy has slipped into a recession, as industrial production figures and employment data show that the economy is in retreat on many fronts. Yet several factors suggest that this recession will be milder than the typical downturn. Inventories are in better shape; exports appear healthy; interest rates have already fallen significantly; and the credit crunch appears limited to commercial real estate projects, not to the economy as a whole.
- The two halves of 1991 are expected to be quite different. During the first half, the economy is projected to contract at a 1.2 percent annual rate. But lower interest rates, stronger export activity and renewed consumer confidence should allow for 3.0 percent annual growth in the second half of the year.
- A robust 9.3 percent increase in the pace of housing starts during November broke a nine-month string of declines. Rather than a sign of a reviving economy, the figure probably represents a rebound from October's large 6.6 percent decline to a more sustainable level of starts activity. Housing starts are not expected to reach bottom until the first quarter of 1991. A recovering economy and lower mortgage rates will spur home building in the second half of 1991.
- The new home sales rate climbed back over the half-million mark in November, and sales are expected to average 495,000 in the final quarter of 1990, down 6.1 percent from the third quarter. With housing starts expected to continue its descent during the projected mild recession, sales of new homes will also be falling. On a brighter note, mortgage rates have already started falling, and, by the second half of 1991, the economic recovery will foster an increase in demand for new homes.
- Existing home sales posted a 3.0 percent gain in November. The increase follows two months of significant declines. Despite the rebound, the market remains troubled. Sales for 1990 are expected to be 5 percent below 1989's sales volume. The worst may be behind us, however, as lower mortgage rates will lead to modest gains in the first half of 1991, and economic recovery in mid-1991 should further spur the market.

IN THIS ISSUE

- [illegible]
- [illegible]
- [illegible]

NATIONAL ASSOCIATION OF REALTORS®
REALTOR®
The Voice for Real Estate™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991 NATIONAL ASSOCIATION OF REALTORS®

You Fret Your Life

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

Anyone with children knows that you spend your life worrying about the wrong things. Most of the time it's like that with the economy as well -- maybe that's just the fate of mankind. So, as we begin the new year, we offer some things that should be worrisome.

But first, let's examine what the body politic is concerned with. Such a list would include (in no particular order) the prospects for war in the Gulf; the deterioration of society caused by drugs, a failing educational system and a growing underclass; the precarious state of the financial system; slumping housing markets; the Federal deficit; impending recession; and competition from abroad.

All of these are important, of course, since any one or all of them will impact our individual and collective lives in the short term. But we can do little about them now. In every case, there are forces in motion -- the will of Saddam Hussein, the state of Japanese technology and organization, the Congressional budget process (among others) -- that will determine their impact on our society. Worry is a natural, but impotent, response.

Yet each one of these cares comes from the seed of a longer term concern about which we can do something, and therefore should worry. The early years of the Nineties will be a period of almost continual change in all areas, including the economy. By worrying now for the future, we can make those changes we must to shape that future. Let's look at each of these:

1. The banks are going to fail. No, they're not. Despite the rush to hitch the commercial banking system to the savings and loan millstone, the differences are legion. Right now, the problem loans at banks are increasing and putting a strain on the insurance fund, but not enough to sink it. But in the future the evolution of financial services that has so transformed the familiar landscape of the banking system will only accelerate as new, uninsured, transnational channels for the flow of funds come into prominence. Nowhere will this be felt more than in real estate finance (in its broadest form). If we can shape this change the right way, the flow of funds to real estate in the future will be secure. Let's worry about that.

2. Housing markets are in deep trouble. Not in the long run, although an index based on the price of reporters' homes in Northern New Jersey may lead you to think so. The nature of housing is to be cyclical, as soaring prices bring oversupply and then correction. The longer the market soars, the longer the correction will be. It has been ever thus, and so it will be. That doesn't take the sting out of the Northeast but does explain what's happened (and is happening) in Houston and Dallas. But, the population is changing and before the end of the decade those changes will crucially affect the real estate business. The aging postwar generation will see its own American dream change from the suburban center hall colonial with a quarter acre to a low maintenance, high amenity condo in reach of leisure activities. Realtors don't build houses, but we do deal with people and adapting to these changes will be a real challenge. That's worth worrying about.

3. Tinhorns like Saddam will be a continual thorn in the side of the U.S. Maybe, and maybe not: it all depends on how we will deal with the tinhorn *de jour*. War in the current instance seems like a tragic overreaction but may serve to extinguish like ideas in others. Yet, it's probably more important what we do afterwards. The Nineties will see increasing economic pressure from the growing populations of not only the Muslim world, but also Latin America, Africa and South Asia. In addition, those new citizens of the Third World in Eastern Europe and the Soviet Union will seek the means of development. There's only one source to meet these demands -- the industrialized nations. A failure to integrate successfully the have-nots into the community of developed nations will be the surest cause of continual conflict. This is a global worry.

4. We're saddled forever with a profligate public sector. Growing savings from the postwar generation and an exploding Social Security Trust Fund ought to make current deficits a memory by the mid-Nineties. But by that time, the U.S. must have made a decision to invest more into its capital resources. The private sector needs to modernize its plant to compete in a world market; the public sector needs to replace the bridges, tunnels, and roads that link us. Most importantly, we need to make a major investment in human capital to build our educational systems and to reclaim those resources being destroyed in our cities. That may be the biggest worry of all.

No economy exists by itself. It is fed and nourished by a financial system and shaped and controlled by a political system. What really makes this a time of anxiety is that the three are out of synch. With its capacity to move any amount of funds across any distance instantaneously at anytime, the financial sector is leading us into the Twenty-first Century. Our economy, advanced in some areas and laboring in others, is still rooted in the Twentieth Century. Our political system, with its continued stress on turf and national identity, is firmly mired in the Nineteenth Century. And as the challenges build around us, the real worry is whether we can line these three up in a way that will let us solve the riddle of the future.

By now, you're reaching for the aspirin bottle, and it's not because of New Year's Eve. But, as the ghost of Christmas future told Scrooge, these are only things that *might* be, not *will* be. Or, in the words of Groucho Marx, "It's been very pleasant talking to you, but now it's time to play the game."

Outlook for the Economy and Real Estate

The sounds you've been hearing from the nation's economic data mills are the sour notes of a recession. The nation's economy is contracting -- and at a sharper pace than had been generally anticipated. The tenor of the most recent statistics is that the weakness is becoming increasingly widespread. Both the industrial production figures and the employment report show that the economy is in retreat on most fronts.

Yet several factors suggest that this recession will be milder than the typical downturn. (For more details on how this downturn stacks up with the eight previous post-World War II recessions, see pages 8-11.) Inventories are in better shape; exports appear healthy; interest rates have already fallen significantly; and the credit crunch appears limited to commercial real estate projects, not to the economy as a whole.

The projections presented here assume a diplomatic solution to the Persian Gulf crisis. The outbreak of a shooting war would deepen and lengthen the recession as oil prices rise. Interest rates would shoot up, and consumer confidence may sink further. One key to the war's impact on the economy would be any damage done to oil fields and pipelines in the Mideast.

Fourth Quarter of 1990 Turns Down

It appears that the recession began sometime between August and October, and that the fourth quarter of 1990 will be the first quarter in which the economy recorded negative growth. NAR's current forecast places this figure at an annual rate of 2.2 percent. Estimates from an informal survey of the nation's top economists on the fourth quarter's contraction range from 2.0 percent to 3.0 percent.

With the Federal Reserve's more aggressive easing in recent weeks, this month's forecast projects significantly lower interest rates than previously forecasted. Mortgage rates, for example, were expected to average 9.6 percent in both 1991 and 1992 in last month's outlook, but are now anticipated to average 9.2 percent in 1991 and 9.0 percent in 1992. By having the usual stimulative effect in housing and other markets, the lower interest rates will play an important role in keeping the recession mild.

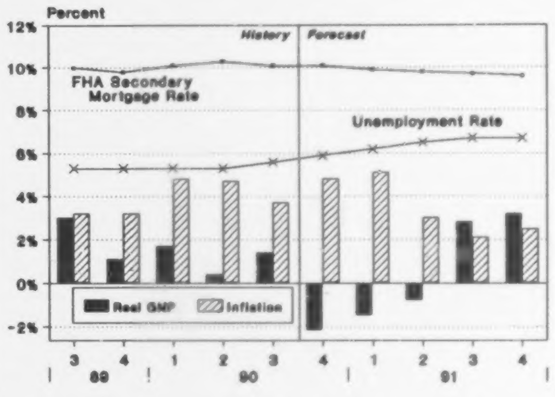
Consumers Call the Tune

This recession appears to be different than the typical postwar recession: Worried consumers rather than battered businesses seem to be calling the tune. Generally, consumers, while trimming their spending growth, add at least some strength to the economy during a recession. Businesses, meanwhile, find themselves with bloated inventories at the outset of a recession and consequently cut production drastically. But this time businesses appear to have kept inventories in check -- while shaky consumer confidence, eroding real personal income, and high debt levels have led consumers to keep their checkbooks closed.

Employment Stronger Than Expected

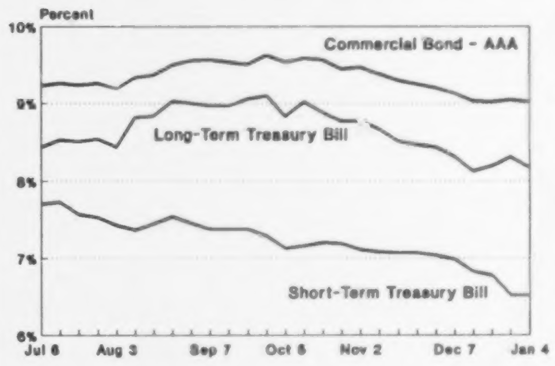
While marking the sixth consecutive monthly decline in payroll employment, December's loss of 76,000 workers was much more modest than November's decline of 259,000. Many analysts had expected a much larger decline in December, and the relatively small decline is

The Economic Outlook



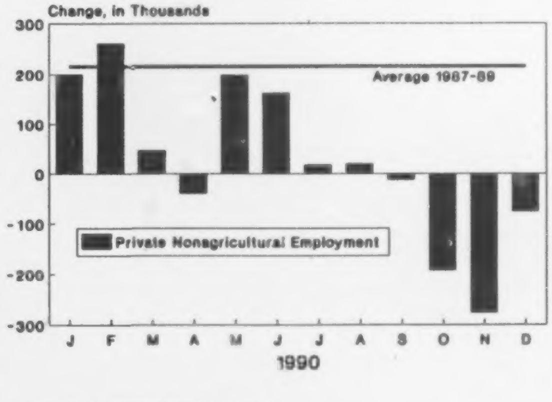
Sources: Bureau of Economic Analysis; NAR forecast

Relief to Come from Sliding Interest Rates



Source: Federal Reserve Board

Employment Reflects Weak Economy



Source: Bureau of Labor Statistics

another indication that the recession will be mild. The unemployment rate in December rose to 6.1 percent, its highest level in over two years.

Widespread Weakness in Industrial Production

Industrial production dropped sharply at year end, falling at a 10.4 percent annual rate between September and November. The data confirms the widely recognized difficulties in the automotive industry as the production of automotive products fell at an astounding 38.3 percent annual rate between September and November. But the most striking feature of the data is that the weakness is not isolated. Production of other consumer durable goods during this period was down by a 15.4 percent annual rate, and nondurable goods, such as food, clothing, and energy, fell 5.8 percent. Of the one dozen major market groupings for consumer goods, an increase was registered in only one category: paper products, up 4.1 percent.

The weakness was not limited to consumer goods, as production of business equipment dropped at a 7.4 percent annual rate between September and November. Defense equipment, even during the period when the U.S. was gearing up for Operation Desert Shield, experienced a 4.4 percent decline. The bottom line on the industrial production figures is that the downturn has spread from a few troubled industries to encompass much of the economy.

Low Money Growth Gives the Fed More Room to Ease

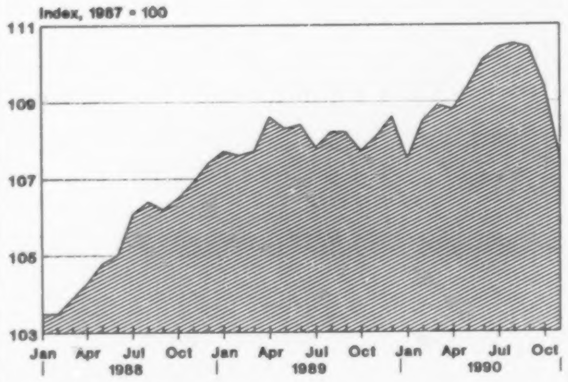
The monthly employment reports induced the Federal Reserve to ease monetary policy by lowering the target ranges on the closely-watched fed funds rate. After spending most of October and early November around 8.0 percent, the fed funds rate fell to 6.5 percent by the first week of the new year. Another key short-term interest rate, that on 3-month Treasury Bills, sunk below 6.5 percent in early January, a full point below its level in mid-August.

The Fed was also prompted to act by the sluggish growth seen in the money supply measure known as M2, since too little money growth is a sign of a faltering economy. For 1990, the Fed targeted M2 growth between 3 and 7 percent. By easing credit policy over the last few weeks, the Fed hopes to encourage bank lending, an activity which increases the money supply, and, presumably, economic activity. Too much money growth, of course, leads to higher inflation, but M2 is in danger of falling below the Fed's lower target range, as shown in the chart at right. During the 1982-89 expansion, M2 growth averaged 7.4 percent per year; in the 12 months since December 1989, M2 has grown at a 3.1 percent rate.

A Jeckyl and Hyde Economy in 1991

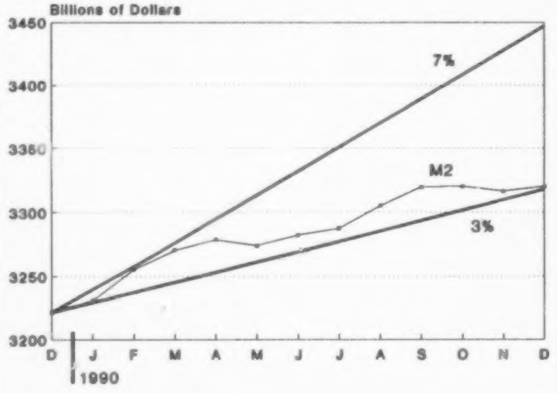
The two halves of 1991 are expected to be quite different. During the first half, the economy is projected to contract at a 1.2 percent annual rate. But lower interest rates, stronger export activitiy and renewed consumer confidence should allow for 3.0 percent annual growth in the second half of the year. This represents a recovery more modest than most, but then the recession itself is expected to be milder than usual. For the year, the economy will contract 0.2 percent, relative to 1990's sluggish 0.9 percent gain. The recovery should continue into 1992, with the economy growing 2.9 percent.

Industrial Production Loses Ground



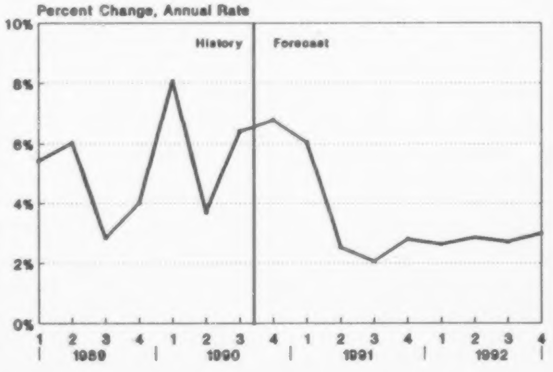
Source: Federal Reserve Board

Money Supply Growth: Actual & Targeted



Source: Federal Reserve Board

Pressure on Consumer Prices To Ease



Sources: Bureau of Labor Statistics, NAR forecast

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

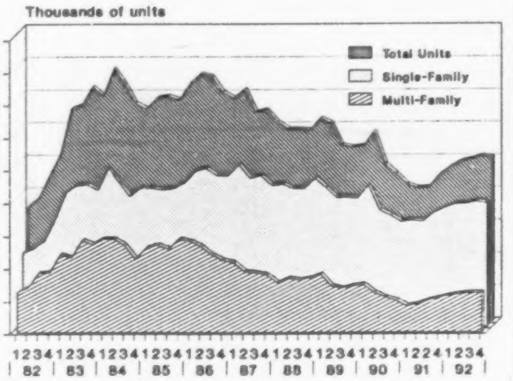
	Total	SF	2-4	5+
Nov 1989	1,347	1,010	47	290
Jul 1990	1,153	875	29	249
Aug 1990	1,131	836	30	265
Sep 1990	1,106	859	34	213
Oct 1990	1,033	856	21	156
Nov 1990	***1,129***	***772***	***43***	***314***
Annual Averages:				
1988	1,491	1,086	59	347
1989	1,386	1,010	55	321
Percent Changes in November 1990 since:				
Nov 1989	-16.2	-23.6	-8.5	8.3
Oct 1990	9.3	-9.8	104.8	101.3

Regional Data

	Northeast	Midwest	South	West
Nov 1989	179	296	498	374
Jul 1990	113	225	493	322
Aug 1990	120	241	434	336
Sep 1990	104	239	445	318
Oct 1990	142	237	394	260
Nov 1990	***140***	***237***	***478***	***274***
Annual Averages:				
1988	240	273	574	404
1989	183	270	536	397
Percent Changes in November 1990 since:				
Nov 1989	-21.8	-19.9	-4.0	-26.7
Oct 1990	-1.4	0.0	21.3	5.4

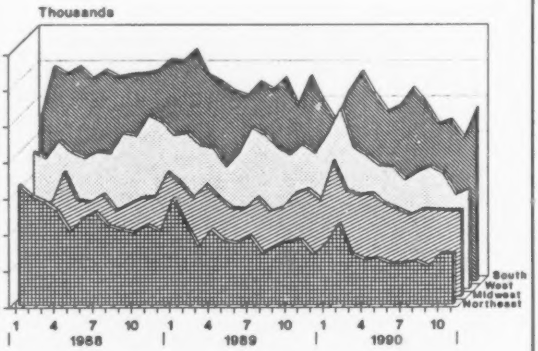
Source: Bureau of Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of Census

A robust 9.3 percent increase in the pace of housing starts during November broke a nine-month string of declines. Rather than a sign of a reviving economy, the figure probably represents a rebound from October's large 6.6 percent decline to a more sustainable level of starts activity. The annual rate of 1,129,000 units is 16.2 percent below the rate recorded in November 1989, and the levels reached during the fourth quarter of 1990 are the lowest since the end of the last recession in October 1982. Relative to the first eleven months of 1989, the pace of housing starts so far this year is down 11 percent. Single-family starts are down 8 percent; multi-family starts are down over 19 percent.

All of November's gain is accounted for by multi-family housing starts. The rate of starts doubled from 177,000 units in October to 357,000 units in November. Again, the jump in November probably does not signal renewed strength in the housing markets; rather, it likely represents a return from a very poor October. As a comparison, multi-family starts averaged 318,000 units nine months of 1990.

Almost 90 percent of November's increase occured in the South, where starts were up 21.3 percent.

Housing starts are not expected to reach bottom until the first quarter of 1991, when they are projected to average 1,022,000 units. A recovering economy and lower mortgage rates will spur home building in the second half of 1991, and healthy gains in 1992 are expected as well.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

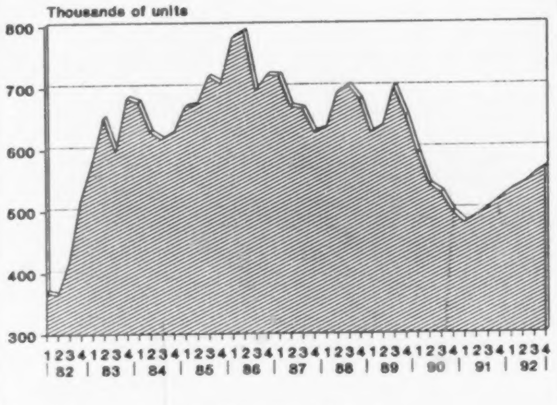
		Mo. Ago % Chg.	Yr. Ago % Chg.
Nov 1989	687	8.0	5.7
Dec 1989	633	-7.9	-5.4
Jan 1990	613	-3.2	-12.9
Feb 1990	606	-1.1	-2.7
Mar 1990	558	-7.9	0.4
Apr 1990	533	-4.5	-12.6
May 1990	536	0.6	-17.7
Jun 1990	550	2.6	-14.9
Jul 1990	541	-1.6	-27.0
Aug 1990	527	-2.6	-26.7
Sep 1990	507	-3.8	-20.5
Oct 1990	492	-3.0	-22.6
Nov 1990	***506***	***2.8***	***-26.3***
Annual Averages:			
1988	676		0.8
1989	654		-3.3

Regional Data

	Northeast	Midwest	South	West
Nov 1989	96	117	263	211
May 1990	71	91	215	159
Jun 1990	80	94	233	143
Jul 1990	70	93	238	140
Aug 1990	63	88	238	138
Sep 1990	56	96	219	136
Oct 1990	80	78	223	112
Nov 1990	***81***	***84***	***221***	***120***
Annual Averages:				
1988	101	98	271	206
1989	90	103	258	202
Percent Changes in November 1990 since:				
Nov 1989	-15.6	-28.2	-16.0	-43.1
Oct 1990	1.3	7.7	-0.9	7.1

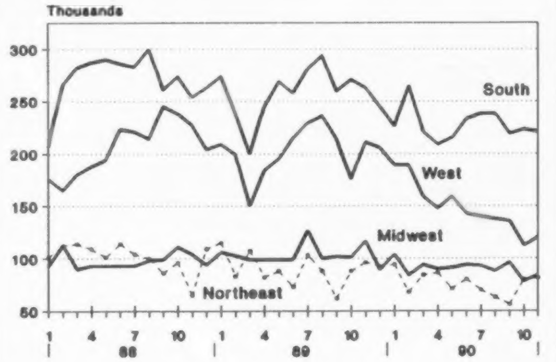
Source: Bureau of Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of Census

The new homes sales rate climbed back over the half-million mark in November, when the annual pace rose 14,000 units to 506,000 units. While the increase is welcome news, it stands as only one of three months in the previous twelve that sales increased, and the month's sales pace was more than one-quarter below the sales rate of November 1989.

The Northeast was able to extend its impressive October increase into November, generating a sales pace in these two months that was almost 8 percent higher than the average sales rate of the year's first nine months. While remaining almost 16 percent below the rate set in November 1990, the month was the strongest in the region since April. The Midwest and the West registered strong gains in November, up 7.7 percent and 7.1 percent, respectively. The South dropped almost one percent.

Sales of new homes are expected to average 495,000 in the final quarter of 1990, down 6.1 percent from the third quarter. With housing starts expected to continue its descent during the projected mild recession, sales of new homes will also be falling. The bottom will be reached in the first quarter of 1991, when the sales rate is expected to reach 478,000 units. Mortgage rates have already started falling, and, by the second half of 1991, the economic recovery will foster an increase in demand for new homes. The buying opportunities afforded by lower mortgage rates and rising incomes in late 1991 and into 1992 may catch home builders short of supply.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

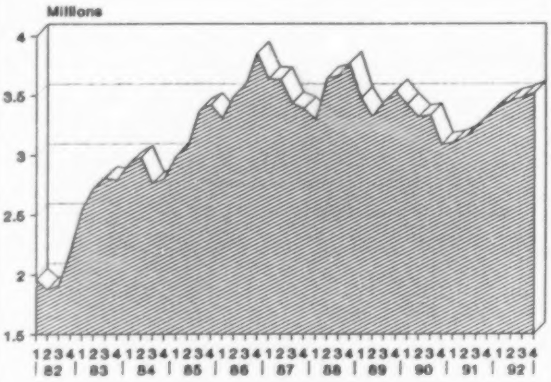
		Mo. Ago % Chg.	Yr. Ago % Chg.
Nov 1989	3,560	2.0	-4.0
Dec 1989	3,560	0.0	-9.2
Jan 1990	3,470	-2.5	-5.2
Feb 1990	3,400	-2.0	-4.2
Mar 1990	3,400	0.0	-0.9
Apr 1990	3,330	-2.1	-3.2
May 1990	3,300	-0.9	1.5
Jun 1990	3,330	0.9	0.0
Jul 1990	3,330	0.0	-1.5
Aug 1990	3,500	5.1	1.7
Sep 1990	3,170	-9.4	-9.7
Oct 1990	3,050	-3.8	-12.6
Nov 1990	***3,140***	***3.0***	***-11.8***
Annual Averages:			
1988	3,594		-1.9
1989	3,467		-3.6

Regional Data

	Northeast	Midwest	South	West
Nov 1989	590	950	1,390	630
Jun 1990	490	960	1,310	580
Jul 1990	560	930	1,310	530
Aug 1990	520	990	1,400	570
Sep 1990	520	870	1,260	520
Oct 1990	500	820	1,230	490
Nov 1990	***490***	***820***	***1,320***	***500***
Annual Averages:				
1988	669	929	1,348	643
1989	590	931	1,320	617
Percent changes in November 1990 since:				
Nov 1989	-16.9	-13.7	-5.0	-20.6
Oct 1990	-2.0	0.0	7.3	2.0

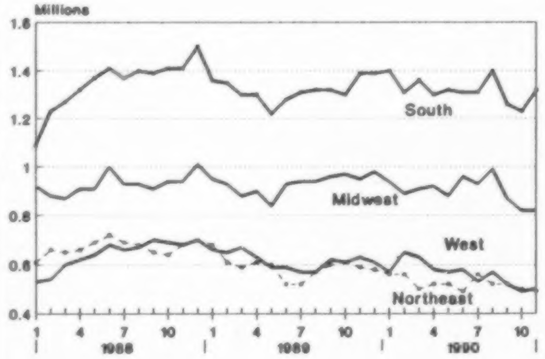
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

Existing home sales posted a 3.0 percent gain in November, with the sales rate at 3,140,000 units. The increase follows two months of significant declines and comes despite declining activity in many key areas of the economy. As was true for housing starts, the strength came from the South, which was up 7.3 percent. A small gain in the West was countered by a small drop in the Northeast, and the Midwest held steady in November.

Despite the rebound, the market remains troubled. Sales in the three-month period ending in November were down 7.9 percent over sales in the previous three month period, and sales for 1990 are expected to be 5 percent below 1989's sales volume. After a 2.7 percent decline in 1991, sales are expected to rebound by 8.2 percent in 1992.

In terms of sales declines, however, the worst may be behind us. Although sales for the year are expected to be down in 1991, the fourth quarter of 1990 is expected to turn out to be the low point for sales. Lower mortgage rates will lead to modest gains in the first half of 1991, and economic recovery in mid-1991 should boost job growth and incomes to further spur the market. Relative to the fourth quarter 1990 figure, the annual rate of increase in sales is expected to be 3.9 percent during the first half of 1991 and 11.7 percent during the second half. Like the other forecasts in this publication, this projection depends importantly on the peaceful resolution of the Gulf crisis.

Single-Family Home Prices

(In Dollars)

National Data

	Median Existing	Median New	Average Existing	Average New
Nov 1989	93,100	125,000	117,900	151,400
Jun 1990	97,500	125,000	121,100	150,400
Jul 1990	98,300	118,700	122,000	149,800
Aug 1990	97,100	118,400	120,500	144,700
Sep 1990	94,400	112,200	116,700	142,100
Oct 1990	92,900	120,000	115,900	153,200
Nov 1990	***91,300***	***121,500***	***115,200***	***146,500***
Annual Averages:				
1988	89,200	113,400	112,500	138,900
1989	92,900	120,400	118,000	148,300
Percent changes in November 1990 since:				
Nov 1989	-1.9	-2.8	-2.3	-3.2
Oct 1990	-1.7	1.3	-0.6	-4.4

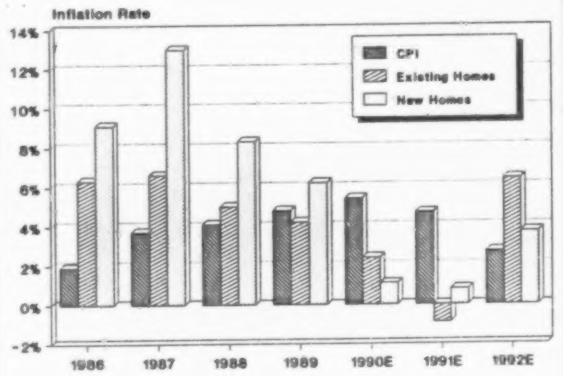
Regional Data

Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Nov 1989	145,700	71,400	82,200	147,100
Jun 1990	148,300	75,900	87,500	138,100
Jul 1990	146,900	76,000	88,800	139,700
Aug 1990	145,300	75,300	86,900	140,200
Sep 1990	137,100	74,200	85,900	134,700
Oct 1990	136,200	72,000	83,200	142,000
Nov 1990	***133,600***	***71,700***	***83,200***	***138,700***
Annual Averages:				
1988	142,500	68,200	82,200	124,700
1989	145,100	71,200	84,400	139,800
Percent changes in November 1990 since:				
Nov 1989	-8.3	0.4	1.2	-5.7
Oct 1990	-1.9	-0.4	0.0	-2.3

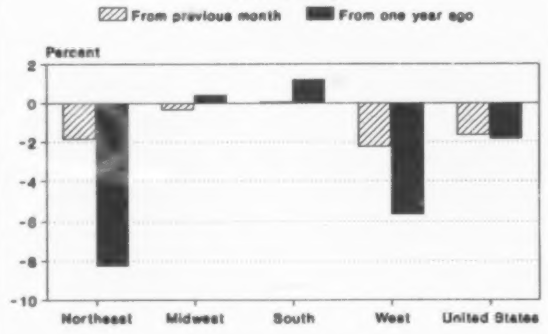
Source: National Association of Realtors,® 'Home Sales'

Home Prices



Source: Bureau of Census; E Real Estate Outlook forecast

Home Prices by Region



Source: NAR Economics & Research

The median price of existing homes fell by 1.7 percent in November to $91,300, $1,600 below October's level. The median price has fallen for four consecutive months and now stands $7,000 below its recent peak in July. The figure is about 2 percent below its year-ago level. The median price for new homes, on the other hand, built on last month's 7.0 percent increase, adding another 1.3 percent to stand at $121,500 in November. This rebound comes after the median price for new homes had dropped $12,800, or 10.2 percent, between June and September. Relative to its level of a year ago, the median price is down by almost 3.0 percent.

Average prices for both existing and new homes fell in November. For existing homes, the average price fell by 0.6 percent to $115,200. The drop was more dramatic for new homes, where average prices slipped 4.4 percent.

The median price of existing homes is projected to drop almost 1 percent in 1991, relative to 1990. Prices are expected to firm as the recovery takes hold and buyers take advantage of lower mortgage rates. An increase of 6.4 percent is projected for 1992.

Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis Division

How Will This Recession Stack Up?

Tiring consumers and the Federal Reserve's inflation-fighting monetary policy brought slow growth to the U.S. economy over the last couple of years. In the last few months, with uncertainty over war and a shock in oil prices, both employment and industrial production have made U-turns. It's apparent that a recession has settled in. Despite this gloomy assessment, the current NAR forecast is relatively optimistic. The economy will not enter a free-fall; in fact, the recession is likely to be mild. Economic expansion should be well under way during the second half of 1991. In comparing the projected downturn with the track record of previous recessions, this article will present the case for a mild recession. Of course, there are sizeable risks to the economy -- particularly the threat of war in the Persian Gulf -- and these will be discussed as well.

Eight Postwar Recessions

A recession is a period of sustained contraction in real GNP, or the inflation-adjusted value of output produced in the economy. The rule of thumb is that two quarters of contraction constitute a recession, but the final call is made by a panel of private-sector economists who look beyond the GNP figures to determine the economy's turning points.

Since World War II, the U.S. economy has weathered eight recessions. The table at right shows the starting and ending dates of the recessions, that is, when real GNP started to fall and, later, when real GNP hit its low point and began to recover. Also shown for each recession are duration and depth, which measures how much the economy contracted from the peak of GNP to its trough. On average, recessions have lasted just under a year and have cut output in the economy by 2.6 percent. The table also shows that the current recession is projected to be two months shorter than the average recession, but, more importantly, that output will drop by only 1.1 percent.

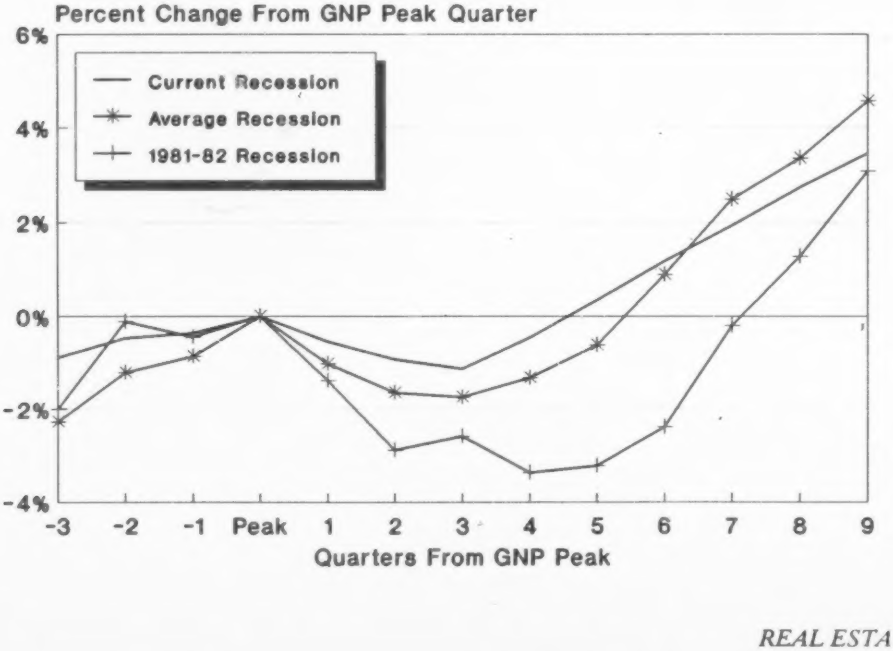
The Eight Post-War Recessions

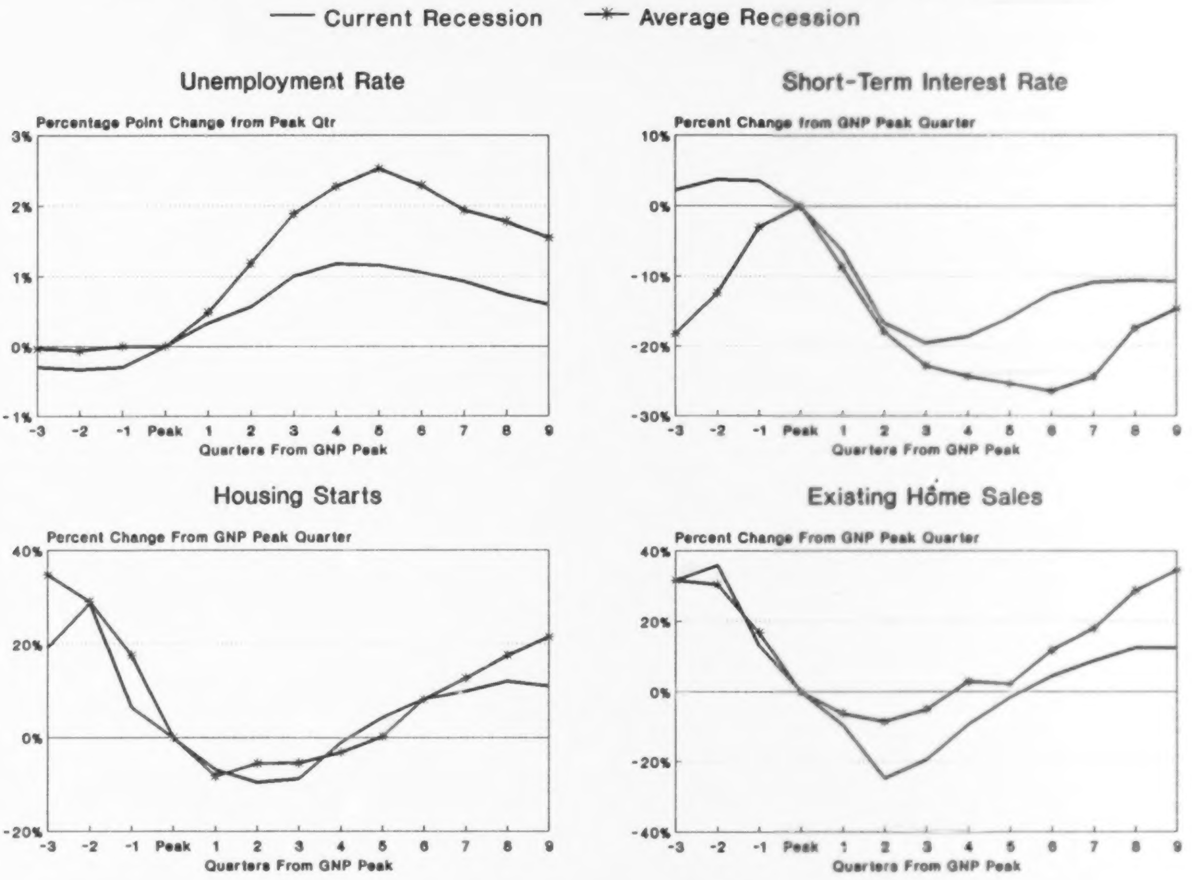
Peak	Trough	Duration	Depth
Nov '48	Oct '49	11	2.0%
Jul '53	May '54	10	3.0%
Aug '57	Apr '58	8	3.5%
Apr '60	Feb '61	10	1.0%
Dec '69	Nov '70	11	1.1%
Nov '73	Mar '75	16	4.3%
Feb '80	Jul '80	6	2.3%
Aug '81	Nov '82	16	3.4%
Average		11	2.6%
Current Forecast		*9*	*1.1%*

Note: Duration in months

This means the recession will be shallower than the average recession. The graph below shows how moderate the current recession is expected to be relative to the average downturn and the 1981-82 slump. The set of charts to the right compare the current recession to the average

Recession/Recovery Comparison: Real GNP





Recession/Recovery Comparison: Current vs. Average

recession for four additional variables, and the charts on the following page compare the current recession to the 1981-82 downturn for those same four variables.

It is interesting to note that for both housing variables, most of the decline in activity occurs in the year prior to the onset of the recession.

Why a Mild Recession?

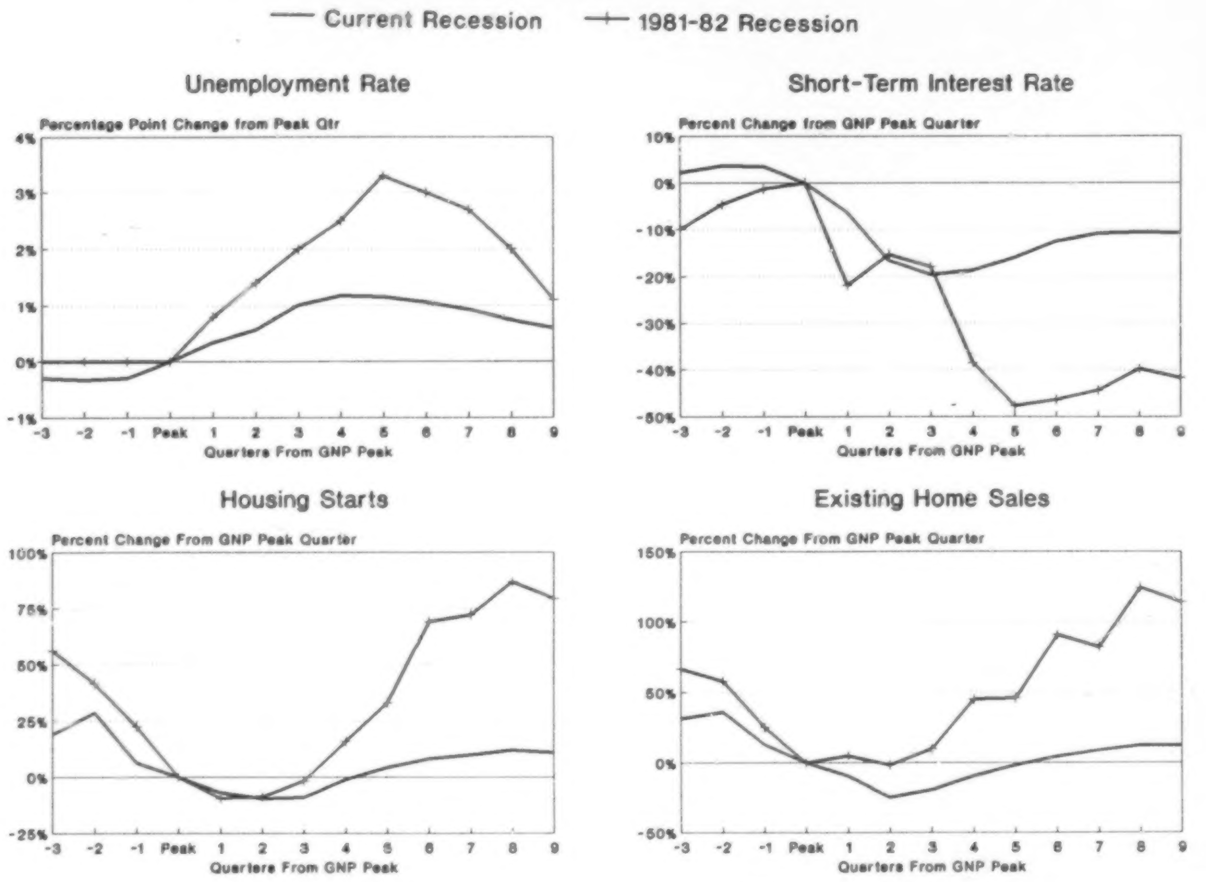
The evidence suggests that several factors are at work to moderate this recession and prepare the economy for several years of growth in the 1990s.

Interest Rates. Despite the spike in rates that occured immediately after Iraq invaded Kuwait, interest rates have been heading downward. The Federal Reserve has eased credit policy to moderate the recession, and rates have responded by falling. The rate on the 3-month Treasury Bill, the short- term interest rate used in the chart above, has fallen a full percentage point in the past six months, to an average of 6.5 percent in the first week of January. The 30-year Treasury yield has fallen a third of a percentage point to 8.2 percent in the same period. Rates on 30-year fixed mortgages have fallen almost one-half of a point. Lower rates are a key to reviving consumer and business activity.

The graph showing the change in short-term rates under the typical recession and in the current recession offers an important reason why this recession is expected to be relatively mild. First, notice how interest rates tumble during a recession. These lower rates are one element that prepares the stage for the ensuing recovery. Next, note how short term rates have typically risen almost 20 percent in the year preceding a recession. Yet this time we see that short-term rates have actually fallen in the year before GNP peaked and the recession began. In other words, interest rates were already headed in the right direction -- down -- when the recession commenced.

Inventories. Typically, the end of a expansion sees a build-up of inventories. Consumers generally begin to pull back on their purchases. Inventories rise, and businesses subsequently cut production back, selling goods out of inventories. Currently, most firms appear to have a good handle on inventories. In the two quarters immediately prior to the 1981-82 recession, inventory investment rose by almost $50 billion. In contrast, in the two quarters prior

Recession/Recovery Comparison: Current vs. 1981-82



to this recession, inventories rose only $14 billion, after adjusting for inflation. Additionally, the inventories-to-sales ratio has remained low, particularly for manufacturers.

Exports. Nonfarm exports grew a robust 8.4 percent over 1990, one of the few bright spots in the 1990 economy. Further gains are expected due to a nearly 15 percent drop in the value of the dollar over the past year. This will make U.S. goods even more attractive in foreign markets. Since most of the drop came in the last six months, the extra kick to exports from the lower dollar has yet to be felt. Of course, the falling dollar also suggests higher prices for foreign goods in the U.S. And exports may be crimped by recessions in Canada, Britian and Australia, as well as slower growth in Japan and Germany. Nevertheless, exports are in better shape now than they have been in most previous recessions.

Inflation. While inflation is not tame, it is currently under much better control today than it was on the verge of the 1981-82 recession. The more inflation initially, the longer is the costly process of unraveling inflationary pressure in the economy. Much of the decline in interest rates during the 1981-82 downturn, as depicted in the graph above, was due to falling inflation rates.

Lower Energy Costs. So far, the run-up in gasoline prices has been much less severe than the increases seen in the two oil shocks of the 1970s. Additionally, the nation is significantly more fuel efficient. In 1988, for example, the U.S. required 20 percent less oil to produce $1,000 worth of output than it did in 1979. Consequently, the squeeze on oil prices will hurt less during this recession.

Of course, this conclusion relies on a major assumption: Current projections assume either a diplomatic solution to the Persian Gulf crisis, or, at worst, a limited confrontation with little damage done to the Mideast's oil fields. If this is the case, the economy can look forward to a decline in gasoline prices. This would not only leave more money in consumers' pockets, but it would allow that money to go further by dampening the inflation rate.

Rebounding Consumer Confidence. During the fall, consumer confidence took a big plunge -- in fact, the biggest plunge of the twenty years on record according to one measure. A quick resolution to the Persian Gulf situation and the tonic of lower interest rates may lead to sizeable gains in confidence by mid-year. This should lead to a revival of consumer activity, although the return will be less triumphant than in previous recoveries as the debt-overhang from the late 1980s will continue to plague the consumer.

Risks To the Forecast

The economy is vulnerable to several risks that could trigger a longer and deeper recession.

War in the Persian Gulf. Oil prices are expected to shoot up if war breaks out. How far depends on expectations about the length of the war, its outcome, and the damage done to oil fields, pipelines, and other facilities. Increased uncertainty will drive up interest rates, as will heightened inflation expectations due to higher oil prices. The recession will certainly run longer and deeper, though how much depends upon a host of noneconomic factors.

Financial Instability. The S&L crisis, the wobbly condition of many banks, and the increase in debt leverage leave many businesses and financial institutions vulnerable to the reduction in cash flow that generally accompanies a recession. The ratios of debt service and interest payments relative to revenues have increased, leaving the firms more financially unstable. An upward jolt in interest rates, due to war, for example, may topple many firms. In such a climate, surviving businesses may be much more reluctant to add the additional debt necessary to expand operations.

Government Policy. Two government policies in particular may harm the chances of recovery. First, the increased scrutiny of financial institutions may be having a chilling effect on lending. The credit crunch, which appears to be a factor only in the commercial real estate industry, remains a concern for residential real estate and consumer and business loans. If banks become overly cautious due to regulatory concerns, the lower interest rates will have less of an impact on reviving a recessionary economy. Second, the federal government, as well as several state governments, are raising taxes during a recession. Although raising taxes is hardly unusual, the timing is. This places another squeeze on disposable income.

How This Recession is Different

By way of concluding, we will take another look at how this recession is different from the average recession in the postwar period. Here we will look at the four components of GNP -- consumers, businesses, foreigners, and government -- and calculate each sector's contribution to economic growth or, in this case, decline.

The table above shows the total real GNP decline to be 2.6 percent during the average recession and 1.1 percent during the projected recession, as discussed earlier. Summing the contributions of the four sectors gives the total growth rate. For example, the contraction in consumer activity during a typical recession causes the GNP growth rate to fall by 0.1 percentage points, as does the contraction in government purchases. Although these sectors together combine for almost 90 percent of the U.S. economy, the declines here are completely offset by an increase in international activity, which typically adds 0.2 percentage points to economic growth during a recession. The reduction in business spending, which usually takes away 2.6 percentage points of growth, can be said to account for the entire decrease in real GNP.

Contributions to Recession

(in percentage points)

	Average	Current
Consumers	-0.1	-0.9
Goods & Services	0.4	-0.6
Residential	-0.5	-0.3
Business	-2.6	-0.9
Plant & Equipment	-0.9	-0.5
Inventories	-1.7	-0.4
Government	-0.1	0.0
International	0.2	0.7
Total Real GNP	**-2.6%**	**-1.1%**

Note: This table breaks down the contribution made by each of the four components of GNP. For example, of the 2.6% total decline in GNP during the average recession, 0.1 percentage points can be attributed to consumers. Summing the contributions of the four sectors yields the total decline in GNP. This method goes beyond providing a simple percent change in each sector by taking account of each sector's relative importance in the economy.

The comparison of the average recession and the current recession demonstrates several points.

The Swing in Consumption Spending. While consumer spending on goods and services is typically reined in during a recession, it nevertheless still adds some strength to a recessionary economy, upping growth by 0.4 percentage points. But in the current recession, spending pulls growth down by 0.6 percentage points -- a full one percentage point swing in the contribution made to GNP growth. This demonstrates how much this is a consumer-led recession.

Inventories Stay Steady. As discussed earlier, inventories are playing a much more moderate role in this downturn. Business spending on inventories takes away 1.7 percentage points from GNP growth during the average recession. During the current recession, however, this will take only 0.4 percentage points from growth.

Bigger Role for Trade. The table illustrates another point made earlier: Exports will contribute importantly to cushioning this recession. Growth in trade will add an additional one-half of a percentage point to growth during the recession.

By Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis

U.S. Economic Outlook: January 1991

Quarterly figures are seasonally adjusted annual rates

	90.2	90.3	90.4	91.1	91.2	91.3	91.4	92.1	1988	1989	1990	1991	1992
U.S. Economy													
Annual Growth Rate													
Real GNP	0.4	1.4	-2.2	-1.5	-0.8	2.8	3.2	3.3	4.5	2.5	0.9	-0.2	2.9
Industrial Production	4.3	3.7	-7.4	-5.5	-2.2	2.5	4.1	3.6	5.4	2.6	1.0	-2.0	3.2
Civilian Employment	0.7	-1.5	-2.3	-0.9	-0.8	-0.0	0.8	1.3	2.3	2.0	0.4	-0.9	1.0
GNP Inflation Index	4.7	3.7	4.8	5.1	3.0	2.1	2.5	2.8	3.3	4.1	4.2	3.9	2.5
Consumer Prices	3.7	6.4	6.8	6.0	2.5	2.1	2.8	2.6	4.1	4.8	5.4	4.7	2.7
Value of the U.S. Dollar	-2.0	-20.7	-19.1	-5.2	0.2	4.3	0.3	-1.2	-4.3	6.2	-9.6	-7.6	0.2
Percent													
Mfg. Capacity Utilization	82.8	82.8	80.7	79.4	78.6	78.9	79.6	80.1	83.9	83.9	82.2	79.1	80.9
Civilian Unemployment	5.3	5.6	5.9	6.2	6.6	6.8	6.8	6.7	5.5	5.3	5.5	6.6	6.4
Percent of GNP													
Federal Tax Receipts	20.3	20.4	20.6	20.7	20.4	20.5	20.6	20.7	20.0	20.2	20.4	20.5	20.7
Federal Expenditures	23.4	23.1	23.4	23.7	23.8	23.7	23.5	23.5	22.9	22.8	23.3	23.7	23.3
Federal Budget Deficit	-3.0	-2.6	-2.8	-3.1	-3.4	-3.2	-2.9	-2.9	-2.9	-2.6	-2.9	-3.1	-2.6
Interest Rates, Percent													
Federal Funds Rate	8.2	8.2	7.6	6.8	6.6	6.6	6.9	7.2	7.6	9.2	8.1	6.7	7.3
3-Month T-Bill Rate	7.7	7.5	7.0	6.2	6.0	6.1	6.3	6.6	6.7	8.1	7.5	6.2	6.6
Prime Rate	10.0	10.0	10.0	9.6	9.4	9.0	9.0	9.0	9.3	10.9	10.0	9.3	9.0
Discount Rate	7.0	7.0	6.9	6.4	6.0	6.0	6.0	6.0	6.2	6.9	7.0	6.1	6.0
Corporate AAA Bond Yield	9.4	9.4	9.3	8.7	8.5	8.4	8.3	8.4	9.7	9.3	9.3	8.5	8.3
30-Year Government Bond Yield	8.7	8.8	8.5	8.0	7.8	7.7	7.7	7.7	9.0	8.4	8.6	7.8	7.7
Mortgage Rates, Percent													
30-Year Fixed Rate	10.3	10.1	10.0	9.5	9.2	9.0	9.0	9.0	10.3	10.3	10.1	9.2	9.0
1-Year Adjustable	8.6	8.4	8.1	7.9	7.8	7.7	7.5	7.5	8.5	9.3	8.3	7.7	7.5
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	4,188	4,164	3,871	3,898	3,934	4,075	4,210	4,314	4,648	4,446	4,174	4,029	4,386
Existing Single-Family Sales	3,320	3,333	3,090	3,106	3,149	3,230	3,328	3,404	3,594	3,467	3,292	3,203	3,466
New Single-Family Sales	540	527	495	478	489	502	517	531	676	654	538	497	548
Housing Starts	1,204	1,130	1,052	1,022	1,029	1,118	1,179	1,224	1,491	1,386	1,210	1,087	1,248
Single-Family Units	895	857	805	816	809	871	910	939	1,086	1,010	910	852	948
Multi-Family Units	309	273	247	206	220	248	269	286	405	377	300	236	299
2-4 Family Units	44	31	28	23	25	28	31	32	59	55	37	27	34
5+ Family Units	265	242	219	182	195	220	238	253	347	321	264	209	265
Mobile Homes Shipped	190	187	187	192	183	193	200	202	218	199	190	192	204
Percent change -- Year Ago													
Total Single-Family Sales	-2.7	-5.5	-13.9	-12.9	-6.1	-2.2	8.8	10.7	0.4	-4.3	-6.1	-3.5	8.8
Existing Single-Family Sales	-0.6	-3.2	-12.6	-9.3	-5.1	-3.1	7.7	9.6	2.4	-3.6	-5.0	-2.7	8.2
New Single-Family Sales	-15.1	-24.7	-24.1	-19.3	-9.4	-4.7	4.4	11.1	0.8	-3.3	-17.6	-7.8	10.4
Housing Starts	-11.1	-15.5	-21.9	-29.8	-14.5	-1.0	12.1	19.9	-8.6	-7.0	-12.7	-10.2	14.8
Single-Family Units	-9.8	-13.9	-18.5	-24.7	-9.5	1.6	13.1	15.0	-5.9	-7.0	-9.9	-6.4	11.4
Multi-Family Units	-14.7	-20.2	-31.3	-44.6	-28.8	-9.3	8.9	39.0	-14.9	-7.1	-20.3	-21.5	27.1
2-4 Family Units	-18.1	-44.6	-47.5	-46.2	-42.8	-9.3	8.9	39.0	-10.0	-5.7	-34.1	-26.8	27.1
5+ Family Units	-14.1	-15.4	-28.5	-44.4	-26.4	-9.3	8.9	39.0	-15.7	-7.3	-17.9	-20.8	27.1
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.2	96.6	92.1	92.4	93.7	94.8	96.7	99.1	89.2	92.9	95.2	94.4	100.5
New Home Prices	126.7	116.4	120.7	121.3	122.2	123.0	124.2	125.6	113.4	120.4	121.8	122.7	127.2
Percent Change - Year Ago													
Existing Home Prices	3.5	1.8	-0.6	-3.7	-2.6	-1.9	5.0	7.3	5.0	4.2	2.4	-0.9	6.4
New Home Prices	6.0	-2.7	-3.0	-1.5	-3.5	5.6	2.9	3.5	8.3	6.2	1.1	0.8	3.7

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy. Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

REALTOR®

EQUAL HOUSING
OPPORTUNITY

A7000-1

REAL ESTATE OUTLOOK

Vol. 4, No. 2

February 1991

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- After several quarters of below-average growth, the economy contracted at a 2.1 percent annual rate in the final quarter of 1990. The recession is likely to be mild relative to past downturns, thanks in part to declining interest rates and better control of inventories and inflation. While many questions remain -- particularly about the war's effect on the economy via oil prices and consumer confidence -- most of the evidence suggests a turnaround at mid-year.
- The Federal Reserve has eased monetary policy in the past few months, but lethargic money supply growth suggests that the stimulus is not carrying as much punch, perhaps due to banks' increased reluctance to make loans. Federal Reserve Chairman Alan Greenspan has testified recently that the central bank is concerned with the money supply's low growth, suggesting that further easing may be imminent.
- A sharp 12.4 percent decline in December's housing starts signals continued weakness in the housing markets. The loss was accounted for by the annual pace of multi-family housing starts, which fell from 359,000 units in November to 232,000 in December. While the Midwest experienced a modest decline, the other three regions recorded double-digit declines in December.
- The new home sales rate remained below the half-million mark during the last three months of 1990. In December, new home sales dropped 6.7 percent from November's level and 27 percent from the level a year earlier. The West was the only region to show positive growth in each month of the fourth quarter. All four regions experienced double-digit declines in new home sales in 1990 from the year before.
- The median price of existing homes broke its string of four consecutive declines by growing a scant 0.1 percent in December. After showing no change in November, the median price for new homes jumped 10.8 percent in December; some retreat from the month's median price of $133,000 is projected in the coming months. December marked the fifth consecutive month that average prices of existing homes fell, dropping 1.3 percent. The average price of new homes, like median prices, increased dramatically by 12.2 percent.

IN THIS ISSUE

NATIONAL ASSOCIATION OF REALTORS®
REALTOR® *The Voice for Real Estate*™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991 NATIONAL ASSOCIATION OF REALTORS®

What Did You Know, and When Did You Know It?

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

When I think back on all the crap
I learned in high school,
It's a wonder I can think at all.

Few of us could avoid being riveted to our TV screens on January 17 and 18; some of us still can't. Despite anticipation, despite media buildup, we were still stunned by war live in our living rooms. The immediacy of conflict was both horrifying and attractive, with emotions ranging from fear for the safety of our troops to curiosity over the video-game quality of aerial combat.

Yet, the more we watched, the less we knew. The bits, pieces and factoids of the war as presented by CNN added up to nothing more than confusing. Information, paradoxically, reduced understanding. And that's a lesson we need to learn in this so-called "information age." It's not how much information you have, it's how well you process and assimilate that information. We will eventually sort out truth and fiction in the desert, but it will take time, patience and wisdom.

The coverage of the war has also shown us something else. The precision of our weapons systems--even the live transmission of pictures of that precision--has impressed on the American public as nothing else the degree to which technology has come to dominate our lives. We have more information, and our economy has adopted information as a basic currency, to a great degree because we have the devices to organize it. So much of what we produce, and the manner in which we produce it, is controlled by mechanisms which did not exist a decade ago, and whose impact we only vaguely understand.

Let's take one very mundane example and illustrate this. Ten years ago, we heard only futuristic references to a system of computerized pricing that would speed retail purchases. Now, we think nothing of a supermarket clerk passing our goods over a scanning device that feeds information to the cash register. The development of Universal Bar Codes (UBC) and optical scanning technology has increased efficiency (even though we're still left with the nagging suspicion that we're being overcharged).

But it's also caused a change in the competitive relationship between manufacturers and retailers by organizing information. Prior to the advent of UBC, manufacturers could both create demand by advertising and create supply by dictating store policies. They could do so because they controlled more information than did the retailer. The UBC system allows the merchant to track more closely product flow and thus allocate (often by charging producers premiums) scarce shelf space. In short, a shift in the balance of information represents a shift in the balance of market power.

This is a small example of the changes that have taken place not only in the American economy, but also in the world economy. Part of the reason for the rise of Japan as a world economic power is the care with which the Japanese accumulate and organize information. The edge in this type of economic system goes to those who can most effectively blend available information and the technology that makes it productive. That's the real meaning of "information age."

The changes that have occurred in the past decade are also part of the reason why the current economy is so difficult to call. So many of our economic models are based on the relationships of the past, and so many of these relationships have been fundamentally altered, that the tea leaves are hard to read. Economists point to past business cycles and predict a long recession; others cite leaner business inventories as a sign that the recession will be short.

The fact is that none of our models has yet captured the role of information and its organization in the economy. Without that, we fly by the seat of our pants. Perhaps the key input to any economic forecast is an analysis of the information that the public receives on the economy and on the war.

The real estate business has been affected more than most by the shift to an information-based economy. This is not surprising since real estate is basically an industry that deals with people and information. The change has occurred from two sides. On the people side, the customers with which we deal have become more sophisticated and have come to expect more in the way of information and service. They expect the Realtor to be competitive in the presentation of information with the electronic and print media. And just as younger audiences are more comfortable with CNN's war coverage, so too are they more demanding of real estate professionals.

On the business side the advent of computerized MLS systems have increased the information flow, and now computerized loan origination networks will link the transaction and financing pieces of the real estate deal much more closely. From there, it's a very small step to the integration of all elements of the process.

All the changes that are occurring in the economy and in the business add up to a significant challenge for both. The effective and productive use of information will be the key to economic success. But getting there will require investment in technological development, equipment and, most importantly, education. The required mix not only uses information and the mechanisms to process it, but also the people who understand -- not just know, but understand.

We've all been impressed by the dividends that technological research and information organization have produced in the military. Now we need to translate those lessons into all the other areas of our collective life.

But my lack of education hasn't hurt me none,
'Cause I can read the writing on the wall.

Outlook for the Economy and Real Estate

Like the Gulf war, it seemed that the recession might be over before it had hardly begun. But, like the Gulf war, the initial optimism has been tempered, and a quick and easy end appears elusive. While it has ceded center stage to the war, the recession is very much with us. Output fell an annualized 2.1 percent in the final quarter of 1990 and should fall another 1.8 percent in 1991's first quarter. The following quarter should see a minor contraction of 0.5 percent before summer brings us economic recovery.

Yet the recession is still likely to be mild relative to past downturns. Interest rates have been heading down, inventories remain in control, and inflation is much better behaved than it was at the beginning of the last recession. While many questions remain -- particularly about the war's effect on the economy via oil prices and consumer confidence -- most of the evidence suggests a turnaround at mid-year. For all of 1991, the economy is expected to contract by 0.2 percent, and 1992 should see growth of 2.7 percent.

Economists Had Their Own Punxsutawney Phil

Like the groundhog who signals the coming of spring, the employment report in early February was widely anticipated as a gauge of the recession's grip on the economy. Bouyed by the unexpected strength in the GNP numbers released the week before, many economists hoped that a thaw might be evident. But the shadows cast by the employment figures scared off much of the newfound optimism, suggesting several more months of recession.

The employment report showed that the unemployment rate crept up another notch to 6.2% in January, a full point above its level just seven months earlier. Meanwhile, payrolls fell by 232,000 jobs, and revisions doubled December's original estimate of job losses to 148,000. Given that these figures are already seasonally adjusted, the usual declines in employment due to seasonal variations (for example, in retail and construction) can't explain the sharp drop. What can explain it is a faltering economy.

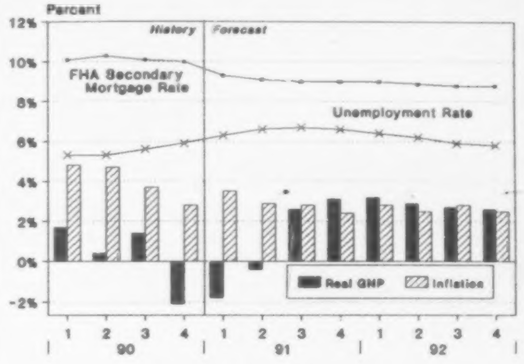
Further evidence of the troubled economy comes from the industrial production report. In the final quarter of 1990, output at the nation's factories, mines and utilities fell at a 12.1 percent annual rate. Production of autos and related equipment nose-dived at a 62.7 percent annual rate. With further cuts in automobile production already announced for the current quarter, industrial production is not expected to rebound until spring.

Modest GNP Decline in Fourth Quarter

The fourth-quarter GNP numbers were widely expected to show a sharp decline, perhaps in excess of 3.5 percent. The fact that the figure showed a decline of only 2.1 percent was taken as good news -- the economy was in better shape than had been thought. Inventories fell during the quarter, instead of stacking up as is usually the case early in recessions. This implies that businesses in general will be under less pressure to slash production over the next few months.

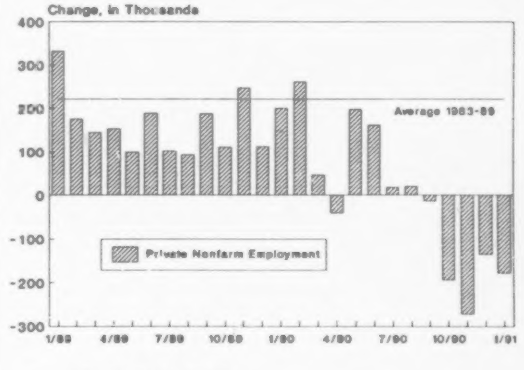
Spending by anxious consumers in the fourth quarter fell at a 3.1 percent annual rate, in line with expectations. With consumer confidence still low, another, though more modest, decline is expected in the current quarter.

The Economic Outlook



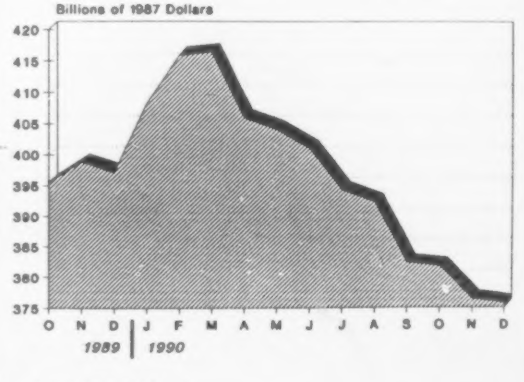
Sources: Bureau of Economic Analysis; NAR forecast

Employment Growth Erodes



Source: Bureau of Labor Statistics

Construction Continues to Slide



Source: Bureau of Census

The Fed Acts to Fight Recession

Short-term rates are more strongly influenced by the Federal Reserve's monetary policy, and these rates have been falling substantially. The chart at right shows the interest rate on federal funds, which banks loan overnight among themselves. The Fed has targeted the interest rate in the federal funds market to 6.25 percent, two percentage points lower than it was in the fall. The most recent cut in the target rate came within an hour of the release of January's poor employment figures on February 1.

But so far the Fed's easing has been running into the brick wall of the credit crunch, as shown by the recent lack of growth in the money suppply. Normally, an increase in credit by the Fed provides more funds for banks to lend, and the banks generally lower rates to attract new customers. When made, the loans become additions to the money supply. But now, with banks using the funds to improve their capital ratios and businesses and consumers holding back on borrowing, new loans are not being made as quickly. Consequently, even though rates have fallen, money supply growth remains low. Fed Chairman Alan Greenspan has testified recently that the central bank is determined to spur money supply growth, indicating that further ease in monetary policy may be forthcoming if money supply growth continues to languish.

The Outbreak of War

In recent months, most baseline economic forecasts handled the Persian Gulf standoff by assuming a diplomatic solution or, at worst, a quick and decisive Allied victory. If a shooting war broke out, according to most projections, interest rates and oil prices would rise, making the recession longer and deeper. As it turned out, the projections were correct -- for about four hours. The movements in the market were as expected, but instead of covering weeks or maybe months, it covered only hours.

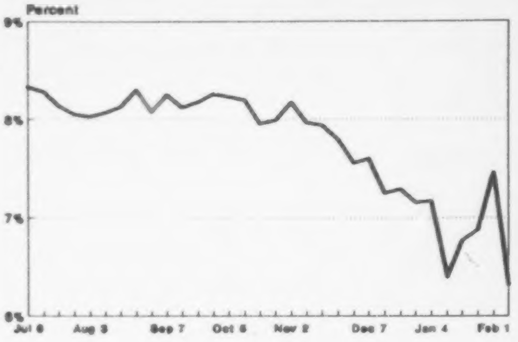
This surprising compactness of events resulted from the overwhelming success of the Allied bombing raids on the night of January 16. As the weakness of the Iraqi response became clear, world markets felt relief. Damage to Saudi oil facilities seemed much less likely, as did a protracted, bloody ground war. Oil prices fell overnight by $10 to $15 per barrel, depending upon grade. As the high uncertainty over the Gulf situation dropped a notch, interest rates dropped.

Less Inflation Leads to Lower Rates

Besides the lessened anxiety over the war, other influences have pushed interest rates down. Lower oil prices suggest lower inflation, scaling back the inflationary premium on long-term interest rates. Since recessions tend to lower the inflation rate, this inflationary expectation component of rates has also been trimmed over the past few months as the certainty of recession increased.

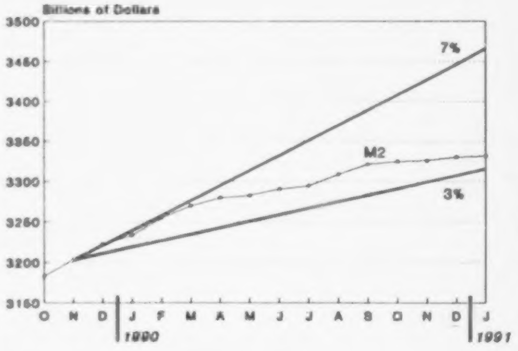
Despite the flare-up in oil prices, inflation is a bright spot in the outlook. In the fourth quarter of 1991, consumer prices rose at a 6.9 percent annual rate, which seems restrained in the face of the third quarter's oil shock. Inflation is projected at 4.5 percent in 1991 and at 3.5 percent in 1992, almost two percentage points lower than 1990's rate.

Federal Funds Market Shows Fed Easing



Source: Federal Reserve Board

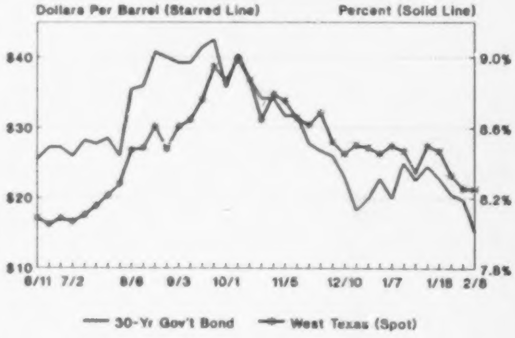
Money Supply Growth: Actual & Targeted



Source: Federal Reserve Board

Success in War Relieves Market Tensions

Oil Prices and Bond Yields



Sources: Data Resources, Federal Reserve Board

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

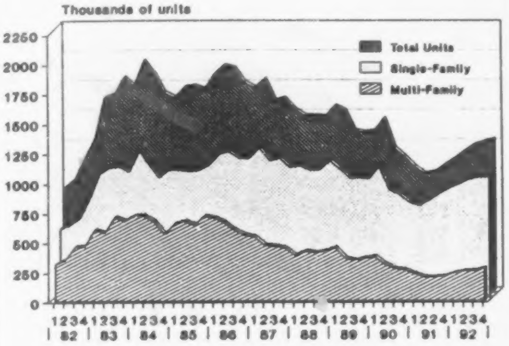
	Total	SF	2-4	5+
Dec 1989	1,273	931	53	289
Aug 1990	1,131	836	30	265
Sep 1990	1,106	859	34	213
Oct 1990	1,026	839	22	165
Nov 1990	1,127	768	44	315
Dec 1990	***987***	***755***	***19***	***213***
Annual Averages:				
1989	1,386	1,010	55	321
1990	1,209	905	37	267
Percent Changes in December 1990 since:				
Dec 1989	-22.5	-18.9	-64.2	-26.3
Nov 1990	-12.4	-1.7	-56.8	-32.4

Regional Data

	Northeast	Midwest	South	West
Dec 1989	138	267	440	428
Aug 1990	120	241	434	336
Sep 1990	104	239	445	318
Oct 1990	144	229	393	260
Nov 1990	142	234	482	269
Dec 1990	***112***	***231***	***409***	***235***
Annual Averages:				
1989	183	270	536	397
1990	136	261	481	331
Percent Changes in December 1990 since:				
Dec 1989	-18.8	-13.5	-7.0	-45.1
Nov 1990	-21.1	-1.3	-15.1	-12.6

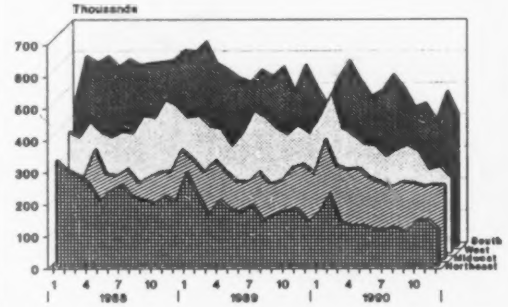
Source: Bureau of Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of Census

A sharp 12.4 percent decline in December's housing starts signals continued weakness in the housing markets and the economy as a whole. The annual rate of 987,000 units is 22.5 percent below the rate recorded in December of 1989, and the levels reached during the fourth quarter of 1990 are the lowest since the end of the last recession in October 1982. Relative to 1989, the pace of housing starts in 1990 was down 12.8 percent. Single-family starts were down 10.3 percent; multi-family starts were down 20 percent.

All of December's loss was accounted for by multi-family housing starts. The rate of multi-family starts fell from 359,000 units in November to 232,000 units in December. As evidenced by the monthly data, multi-family housing starts were quite volatile during the fourth quarter of 1990. Overall, multi-family housing starts averaged 259,000 units during the fourth quarter of 1990, 5 percent below the third quarter's level.

While the Midwest experienced a modest decline, the other three regions recorded double-digit declines in December. The Northeast saw the largest decline, dropping 21 percent from November.

Housing starts are expected to reach bottom during the first quarter of 1991, when they are projected to average 988,000 units. By the second half of 1991, a recovering economy and lower mortgage rates will spur home building, and healthy gains in 1992 are expected as well.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

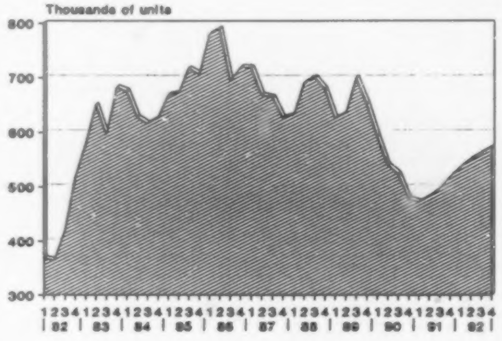
		Mo. Ago % Chg.	Yr. Ago % Chg.
Dec 1989	633	-7.9	-5.4
Jan 1990	613	-3.2	-12.9
Feb 1990	606	-1.1	-2.7
Mar 1990	558	-7.9	0.4
Apr 1990	533	-4.5	-12.6
May 1990	536	0.6	-17.7
Jun 1990	550	2.6	-14.9
Jul 1990	541	-1.6	-27.0
Aug 1990	527	-2.6	-26.7
Sep 1990	505	-4.2	-20.8
Oct 1990	475	-5.9	-25.3
Nov 1990	496	4.4	-27.8
Dec 1990	***463***	***-6.7***	***-26.9***
Annual Averages:			
1989	654		[illegible]
1990	534		-18.3

Regional Data

	Northeast	Midwest	South	West
Dec 1989	92	89	245	206
Jun 1990	80	94	233	143
Jul 1990	70	93	238	140
Aug 1990	63	88	238	138
Sep 1990	61	93	216	135
Oct 1990	77	72	210	116
Nov 1990	74	90	212	120
Dec 1990	***73***	***83***	***184***	***122***
Annual Averages:				
1989	90	103	258	202
1990	75	90	222	147
Percent Changes in December 1990 since:				
Dec 1989	-20.7	-6.7	-24.9	-40.8
Nov 1990	-1.4	-7.8	-13.2	1.7

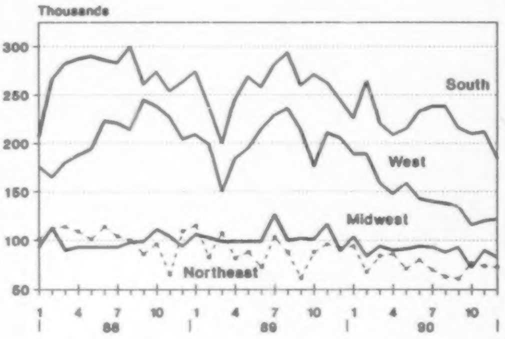
Source: Bureau of Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of Census

The new home sales rate remained below the half-million mark during the last three months of 1990. In December, new home sales dropped 33,000 units to 463,000 units. This decrease translated into a 6.7 percent decline from November's level and a 27 percent decline from the level in December 1989. In 1990, new home sales averaged 534,000 units, 18 percent below the level in 1989.

Although the West recorded 1.7 percent growth in new home sales in December, it was the only region that grew in each month of the fourth quarter. New home sales declined in each of the other three regions during December. The South experienced the largest decline in volume, dropping 13 percent from November. Sales dipped 8 percent from November in the Midwest, while falling a modest 1.4 percent in the Northeast.

All four regions experienced double-digit declines in new home sales in 1990 from the year before. The biggest decline was recorded by the West, which fell by 27 percent. The Northeast saw sales slide by 17 percent, while the Midwest and the South were down by 13 percent and 14 percent, respectively.

Sales of new homes are expected to bottom out during the first quarter of 1991, when they are projected to average 472,000 units. With an economic recovery underway by the second half of 1991, lower mortgage rates and rising incomes will provide a renewed stimulus for the demand of new homes. Sales are expected to increase by almost 13 percent in 1992.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

		Mo. Ago % Chg.	Yr. Ago % Chg.
Dec 1989	3,560	0.0	-7.5
Jan 1990	3,470	-2.5	-5.2
Feb 1990	3,400	-2.0	-4.2
Mar 1990	3,400	0.0	-0.9
Apr 1990	3,330	-2.1	-3.2
May 1990	3,300	-0.9	1.5
Jun 1990	3,330	0.9	0.0
Jul 1990	3,330	0.0	-1.5
Aug 1990	3,500	5.1	1.7
Sep 1990	3,170	-9.4	-9.7
Oct 1990	3,050	-3.8	-12.6
Nov 1990	3,150	3.3	-11.5
Dec 1990	***3,220***	***2.2***	***-9.6***
Annual Averages:			
1989	3,467		-2.5
1990	3,304		-4.7

Regional Data

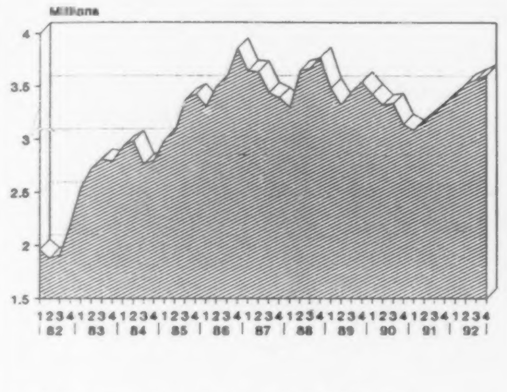
	Northeast	Midwest	South	West
Dec 1989	580	980	1,390	610
Jul 1990	560	930	1,310	530
Aug 1990	520	990	1,400	570
Sep 1990	520	870	1,260	520
Oct 1990	500	820	1,230	490
Nov 1990	510	820	1,310	500
Dec 1990	***490***	***950***	***1,280***	***490***
Annual Averages:				
1989	597	931	1,320	617
1990	521	907	1,316	557
Percent changes in December 1990 since:				
Dec 1989	-15.5	-3.1	-7.9	-19.7
Nov 1990	-3.9	15.9	-2.3	-2.0

Source: National Association of Realtors,® "Home Sales"

Existing home sales registered a 2.2 percent gain in December, with a sales rate at 3,220,000 units. This represents the second consecutive increase in existing home sales and comes despite declining activity in many key areas of the economy. Robust sales activity in the Midwest, which was up 16 percent, countered modest declines in each of the other three regions in December. In the Northeast, December's sales volume was down by 4 percent. Sales in the South and the West declined by 2 percent in December.

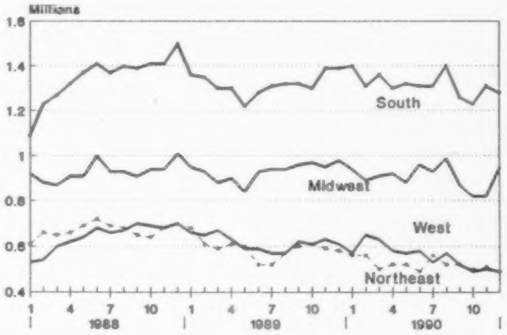
Despite the rebound, the housing market remains weak. Sales in the fourth quarter of 1990 were down 6 percent over sales in the previous quarter. In 1990, sales were 4.7 percent below 1989's sales volume.

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

Although sales for the year are expected to be down by 3 percent in 1991, the low point is expected to come in the first quarter of 1991. Existing home sales are estimated to fall to 3,085,000 units during the first quarter of 1991. After the first quarter, sales are expected to edge their way back up and will reach 3,163,000 units during the second quarter of 1991. The factors which are expected to boost both housing starts and new home sales in the second half of 1991 -- lower mortgage rates and economic recovery -- will spur sales of existing homes as well. This will carry into 1992, when sales are projected to increase by 10 percent.

Single-Family Home Prices

(In Dollars)

National Data

	Median		Average	
	Existing	New	Existing	New
Dec 1989	92,500	125,200	118,100	154,300
Jul 1990	98,300	118,700	122,000	149,800
Aug 1990	97,100	118,400	120,500	144,700
Sep 1990	94,400	113,000	116,700	142,100
Oct 1990	92,900	120,000	115,900	152,700
Nov 1990	91,800	120,000	115,500	145,700
Dec 1990	***91,900***	***133,000***	***114,000***	***163,500***
Annual Averages:				
1989	92,900	120,400	118,000	148,300
1990	95,200	122,700	118,300	150,000
Percent changes in December 1990 since:				
Dec 1989	-0.6	6.2	-3.5	6.0
Nov 1990	0.1	10.8	-1.3	12.2

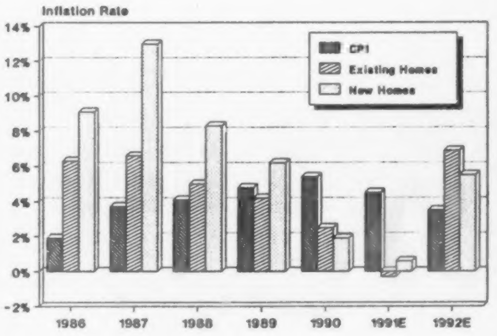
Regional Data

Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Dec 1989	143,400	72,500	82,700	135,200
Jul 1990	146,900	76,000	88,800	139,700
Aug 1990	145,300	75,300	86,900	140,200
Sep 1990	137,100	74,200	85,900	134,700
Oct 1990	136,200	72,000	83,200	142,000
Nov 1990	134,200	71,400	83,500	139,700
Dec 1990	***133,700***	***72,800***	***83,000***	***130,500***
Annual Averages:				
1989	145,100	71,200	84,400	139,800
1990	141,[illegible]00	74,100	85,600	139,500
Percent changes in December 1990 since:				
Dec 1989	-6.8	0.4	0.4	-3.5
Nov 1990	-0.4	2.0	-0.6	-6.6

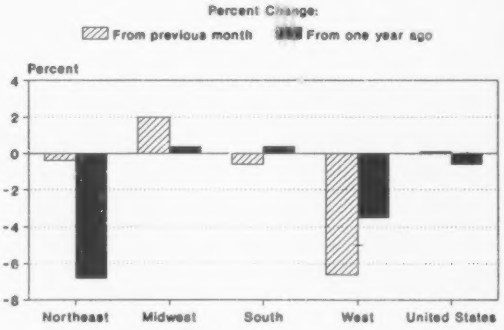
Source: National Association of Realtors,® "Home Sales"

Home Prices



Source: Bureau of Census; E Real Estate Outlook forecast

Home Prices by Region



Source: NAR Economics & Research

The median price of existing homes broke its string of four consecutive declines by growing a scant 0.1 percent in December. The median price currently stands at $91,900, which is 0.6 percent below its year-ago level. After showing no change in November, the median price for new homes jumped 10.8 percent in December. The figure stands at $133,000, up $13,000 from November. With such a large increase, some retreat is projected to occur in the coming months. For all of 1990, the median price of new homes was up by 1.9 percent.

December marked the fifth consecutive month that average prices of existing homes fell. The 1.3 percent decline brought the average down to $114,000. This represents a 6.5 percent decline from its peak of $122,000 in July. In the market for new homes, average prices, like median prices, increased dramatically. The 12.2 percent rise brought the level to $163,500 for December.

A projected decline of only 0.3 percent in 1991 will keep the median price of existing homes close to the 1990 level. As the economy recovers and buyers take advantage of lower mortgage rates, prices are expected to firm. The median price of existing homes is projected to increase by 7 percent in 1992.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

THE REVENUE RECONCILIATION ACT OF 1990:

TAX OUTLOOK FOR THE REAL ESTATE SECTOR

After a nine-month process, the Omnibus Budget Reconciliation Act of 1990 (OBRA) became law in November of last year. Hailed by some as the largest deficit reduction measure but scorned by others as the largest tax increase ever enacted, OBRA contains many significant changes to the federal tax law. The following report provides a short summary of the major federal tax changes affecting the real estate sector contained in Title XI of OBRA known as the Revenue Reconciliation Act of 1990 (RRA).

Tax Rates: Letting Some Air out of the Old "Bubble"

One of the goals of the Tax Reform Act of 1986 (TRA) was tax simplification. TRA collapsed the number of marginal tax brackets from 14 to 2, a 15-percent bracket on the first increments of income earned and a 28-percent bracket on additional income. Between a certain range of taxable income (adjusted gross income minus exemptions and deductions), however, a 5-percent surcharge was added on to the 28-percent tax rate.

The surcharge was a means of phasing out the benefits of the 15-percent bottom tax bracket and the personal exemptions for high-income taxpayers until such benefits were reduced to zero at which point the 28-percent marginal rate applied. Thus, the marginal tax rate for these taxpayers was pushed from 28 to 33 percent, creating a "bubble" in the marginal tax rate.[1]

Under RRA, the 33-percent marginal-tax-rate bubble is eliminated but a new top marginal tax rate of 31 percent has been added to the existing 15- and 28-percent rates. Personal exemptions will still be phased out for upper-income taxpayers, but the phase-out mechanism starts at a different income level from the old phase-out level for each taxpayer. Personal exemptions will be eliminated in steps rather than continuously as they were before RRA.

Beginning in 1991, a new top marginal tax rate of 31 percent starts at the level of taxable income where the old bubble used to start. Single taxpayers will pay 15 percent on the first $20,350 of taxable income; 28 percent on the next $28,950 and 31 percent on the amount above $49,300. Married couples filing jointly will pay 15 percent on the first $34,000 of taxable income; 28 percent on the next $48,150 and 31 percent on taxable income over $82,150. The starting points for each tax bracket will continue to be adjusted for inflation in the future.

By itself, the 31-percent tax rate constitutes a marginal tax rate cut for some taxpayers whose taxable incomes were in the 33-percent bubble range. However, for those taxpayers with incomes beyond the bubble range and subject to a-28 percent marginal tax rate, the marginal tax rate on their income will increase to 31 percent. Because RRA also reinstated the phaseout of personal exemptions and instituted a new limitation on itemized deductions, certain taxpayers could face an effective tax rate higher than 31 percent. Although the 5-percent surcharge creating a bubble in the marginal tax rate was repealed, a smaller marginal-tax-rate bubble will still exist from the creation of the new explicit personal exemption phaseout, leading some to nickname it "Double Bubble" or "Bubble II."[2]

Medicare Hospital Insurance: Cap Increased Nearly 150 Percent

Beginning January 1, 1991, the cap on wages subject to the Medicare Hospital Insurance (HI) payroll tax will increase from $51,300 to $125,000. The HI rates, however, will remain the same, 1.45 percent for each employer and employee and 2.9 percent for self-employed individuals. For example, a taxpayer earning over $125,000 will pay an additional $1,068.65 in HI taxes ($125,000-$51,300 x 0.0145) while the HI taxes of a self-employed individual earning the same income will increase by twice as much at $2,137.30.

Phaseout of Personal Exemptions: Some Win, Some Lose, Large Families Hit Harder

As mentioned above, the new law repealed the old phaseouts of the 15-percent rate and the personal exemptions. However, new phase-out thresholds for personal exemptions were established. As of January 1991, the deduction for the personal exemptions is reduced by 2 percent for each $2,500 or fraction thereof of adjusted gross income (AGI) exceeding $100,000 for single filers and $150,000 for married couples filing jointly. For married couples filing separately, the reduction is 2 percent for every $1,250 or fraction thereof of AGI above $75,000.

These thresholds will also be indexed for inflation in later years and will be terminated after December 31, 1995. The exemption amount will be completely phased out at an AGI above $222,500 for single filers, $272,500 for married couples filing jointly and $136,250 for married couples filing separately.

Since under RRA, the phase-out range of the personal exemptions on AGI is different from that under TRA, some households will be better off, but others will be worse off. Some analysts argue that, in most cases, the phaseout will start at a higher income level and take effect more gradually than it did previously.[3] Other analysts, however, argue that, for some households with a certain numbers of exemptions, the phaseout will kick in at a lower level of income than that under TRA.[4]

Another interesting point – about this provision is that, before RRA, joint filing by married couples was usually more advantageous than separate filing. However, because of the changes made by RRA, in certain cases, married couples filing separately can reduce the impact of the personal exemptions phaseout. For example, in most cases where both spouses earn different incomes and the lesser-earning spouse's income is equal to or less than $75,000 (threshold of AGI filing separately) while the two combined incomes exceeding $150,000 (the threshold for joint filing), filing separately will reduce the couple's tax liability.[5]

Because personal exemptions are reduced by a full two percent even for *a fraction of* $2,500 of AGI over the threshold (for single and joint filers), a spike in the marginal tax rate is created at each $2,500 step over the threshold. For example, a couple with an AGI of $200,000 will earn $50,000 above the threshold. Since $50,000 divided by $2,500 equals 20, they will lose 40 percent (20x.02) of their personal exemptions of $2,150 each which amounts to $1,720 ($4,300x0.4). However, another dollar of AGI pushes the amount over the threshold to $51,001 resulting in a 42 percent ($50,001 divided by $2,500 equals 20.0004 which will be rounded up to 21 and then multiplied by two) loss of their personal exemptions or about $1,806 ($4,300x0.42). Given that their tax bracket is 31 percent, earning an extra dollar of AGI will translate into about $26 higher tax liability ($1,806x0.31 - $1,720x0.31).

The percentage loss in the personal exemptions will apply to each exemption. Thus, larger families claiming greater numbers of exemptions will lose a larger amount than smaller ones. Following the above example, a couple with $200,000 of AGI and three children would lose 40 percent of their personal exemptions totaling $10,750 or $4,300 ($10,750x0.4). As a result of this provision, the couple would owe an additional $1,333 (0.31x4,300) in taxes. In comparison, the same couple without children would owe an additional $533 (0.31x1,720). Thus, given the same AGI, larger families will lose a larger amount of their personal exemptions than smaller families.

"Floor" on Itemized Deductions: Another Sign of Erosion of Mortgage Interest Deductions

RRA's provision limiting itemized deductions, known as the "Pease plan" after its drafter, signals another erosion of deductions for homeowners. The targets of this deduction-recapture provision are mortgage interest deductions, state and local income and personal property taxes and charitable contributions. It does not apply to deductions for medical expenses, investment interest and casualty, theft, and wagering losses. Unlike the provision in the Budget Reconciliation Act of 1987 placing a limit on the mortgage interest deduction on acquisition indebtedness for principal residences of $1,000,000, the 1990 provision will affect a considerably larger number of taxpayers, about 3.6 million households.[6]

The provision calls for a reduction in the non-exempt itemized deductions in the amount of 3 percent of AGI over $100,000 for single filers and married couples filing jointly and over $50,000 for married couples filing separately. The amount of AGI that will trigger the loss in itemized deductions will be indexed annually for inflation in the future and will be effective until December 31, 1995. The reduction of non-exempted itemized deductions could result in a loss of up to 80 percent of the amount of such deductions so that all taxpayers will get at least 20 percent of the itemized deductions they report. For example, a joint filer with AGI of $150,000 and non-exempt itemized deductions of $30,000 will lose $1,500 worth of such deductions ($150,000-$100,000 x.03). With a floor of $1,500, he will not be able to deduct the first $1,500 of his itemized deductions and therefore could deduct only $28,500 ($30,000-$1,500) from his AGI to derive his taxable income.

Some analysts note that this provision represents an indirect way to boost the top marginal rate for the upper-income taxpayers because it is roughly equivalent to a one-percent marginal tax rate increase (three percent times the new 31-percent top marginal tax rate).[7] However, in practice, the provision will be more complicated than a simple rate increase and also will give an unintended and unjustified benefit to the small number of high-income taxpayers who have little or no itemized deductions.[8] Thus, the provision raised the issue of tax equity in that taxpayers who have larger amount of deductions are taxed at a higher rate than those similarly situated taxpayers with small amount or no deductions.

Capital Gains:
Maximum Rate of 28 Percent, But Effective Rate Could be Higher

TRA treated capital gains income as ordinary income and therefore capital gains were taxed as such. In effect, capital gains could be taxed as high as 33 percent if they were realized by taxpayers in the bubble range. Beginning January 1991, capital gains will be subject to a maximum rate of 28 percent even if the taxpayers were in the 31-percent marginal tax bracket. The addition of a top 31-percent marginal tax rate coupled with the return to different rates for capital gains and ordinary income will reduce simplicity intended in the 1986 tax law somewhat.[9]

Although the maximum rate was set at 28 percent for capital gains, the phaseout of the personal exemptions and the limitation on itemized deductions could cause the effective tax rate to be higher than 28 percent for some taxpayers. This is because capital gains are a component of AGI. An increase in AGI will cause taxpayers to lose more of their itemized deductions which will increase their taxable income by more than the increase of the capital gains. Thus, even though the tax rate on the capital gains income is 28 percent, the fact that the increase in the taxable income is more than the increase in capital gains through the loss of the itemized deduction will cause the tax liability to increase by more than 28 percent.

The following Sample Tax Calculation table compares the increase in tax liability of two couples -- middle-income and high income -- as their capital gains income increases by one dollar. It shows how the effective tax rate on the capital gains income can be 28 percent for some but can exceed 28 percent for others.

Couples A and B, each filing jointly, have $20,000 of capital gains income, $30,000 of itemized deductions and two personal exemptions. The only thing that differs is their ordinary incomes, $60,000 for A and $157,000 for B. Since A's AGI is below both the level of AGI triggering the reduction in the itemized deductions and the threshold of personal exemptions phaseout, earning an extra dollar of capital gains, other things being constant, will increase their taxable income by one dollar and thus their tax liability by 28 cents or 28 percent, the maximum tax rate on capital gains.

For couple B, however, earning an extra dollar of capital gains will trigger a loss of three cents in their itemized deductions (line 6) and therefore increase their taxable income by one dollar and three cents (line 11). Although the dollar increase in the capital gains will increase capital gains tax liability by 28 cents, their ordinary-income tax liability will also increase as well resulting in a total increase in their tax liability by almost 29 cents.

Alternative Minimum Tax:
3-Point Increase Parallels Top Marginal Tax Rate Increase

The alternative minimum tax (AMT) was designed to extract taxes from high-income taxpayers and corporations who might have shielded their income from the regular income tax either by receiving various types of tax-exempt income or obtaining large deductions offsetting taxable income. In 1991, the individual AMT rate will increase from 21 percent to 24 percent. The justification for the increase is to match the increase in the explicit top marginal tax bracket from 28 percent to 31 percent.

Sample Tax Calculation
Comparing Effective Capital Gains Rate for Two Income Levels for an Additional Dollar Increase in Capital Gains

(Joint return, two exemptions, 1991 rates)

	Couple A		Couple B	
(1) Ordinary Income	$60,000.00	$60,000.00	$157,000.00	$157,000.00
(2) Capital Gains	$20,000.00	$20,001.00	$20,000.00	$20,001.00
(3) Adjusted Gross Income (1)+(2)	**$80,000.00**	**$80,001.00**	**$177,000.00**	**$177,001.00**
(4) Itemized Deductions	$30,000.00	$30,000.00	$30,000.00	$30,000.00
(5) Percent of Itemized Deductions Allowable	100.00%	100.00%	92.30%	92.30%
(6) Allowable Itemized Deductions (4)x(5)	**$30,000.00**	**$30,000.00**	**$27,690.00**	**$27,689.97**
(7) Number of Personal Exemption	2	2	2	2
(8) Amount of Personal Exemption	$2,150.00	$2,150.00	$2,150.00	$2,150.00
(9) Percent of Personal Exemption Allowable	100.00%	100.00%	76.00%	76.00%
(10) Allowable Personal Exemptions (7)x(8)x(9)	**$4,300.00**	**$4,300.00**	**$3,268.00**	**$3,268.00**
(11) Taxable Income (3)-(6)-(10)	**$45,700.00**	**$45,701.00**	**$146,042.00**	**$146,043.03**
(12) Taxable Income excluding Capital Gains	$25,700.00	$ 25,700.00	$126,042.00	$126,042.03
Ordinary Income Tax Liability				
(13) 15%	$3,855.00	$3,855.00	$5,100.00	$5,100.00
(14) 28%	$0.00	$0.00	$13,482.00	$13,482.00
(15) 31%	$0.00	$0.00	$13,606.52	$13,606.53
Capital Gains Tax Liability				
(16) 15%	$1,245.00	$1,245.00	0.00	0.00
(17) 28%	$3,276.00	$3,276.28	$5,600.00	$5,600.28
(18) Total Tax Liability (12)+(13)+(14)	**$8,376.00**	**$8,376.28**	**$37,788.52**	**$37,788.81**
(19) Effective Marginal Tax Rate		28.00%		28.93%

Motor Fuel and Gas Tax: Rising Costs for Builders, Developers And Real Estate Agents

Before RRA, the Federal excise taxes which was imposed on gasoline and special motor fuels and diesel used in highway transportation were scheduled to expire after September 30, 1993. RRA extended these taxes through September 30, 1995 and also increased them by five cents per gallon.

Low-Income Rental Housing Tax Credit and Mortgage Revenue Bonds:
Expiring Provisions Extended

Currently, a tax credit is allowed for the construction, rehabilitation, or acquisition of qualifying low-income rental housing. The credit is allocated by state or local government authorities subject to an annual limitation for each state. The 1989 deficit reduction legislation reduced the credit allocation from $1.25 to $0.9375 per state resident and extended it only through September 30, 1990. RRA restored the credit allocation for 1990 to $1.25 per state resident and also extended it through December 31, 1991.

State and local governments can issue tax-exempt bonds and use the proceeds to provide low-interest-rate mortgage loans for homeowners with family incomes below a certain level. RRA extended the authority of state and local governments to issue tax-exempt qualified mortgage revenue bonds or mortgage credit certificates from October 1, 1990 through December 31, 1991. Also, the provisions for recapture of the tax subsidies in cases where homes are sold within nine years were also modified.

Estate Freezes:
Repeal of the "Anti-Freeze" Provisions to Estate Planing, You Can't Take It with You, But Now Your Heirs Can.

Before December 17, 1987, business founders could transfer future growth to their heirs in the form of common stock, initially worth little but entitled to all the future appreciation, while freezing the rest of value of their business in the form of preferred stock. Because preferred stock's value remains on the books at par no matter how the business grows, the transaction thereby will freeze the value of business in the parents' estate at its current value, while transferring all future appreciation to the children, keeping the business' future appreciation from being taxed as part of the parents' estate upon their death.

In 1987, Section 2036(c) was enacted to prevent an owner of a substantial interest in an "enterprise" from using estate freeze to avoid transfer taxes by minimizing the transferred or gifted portion and therefore reducing potential gift taxes on the transferred interest. Section 2036(c) was designed to eliminate estate freezes and similar transfers of growth interests to heirs in family-owned businesses.

Section 2036(c) provided that any transfer to a family member of an interest in property that had a disproportionate share of the potential growth of an enterprise could later be brought back and taxed in the estate of the transferor. This estate tax inclusion procedure was criticized by the business community, the bar, and the accounting profession as a substantial barrier to estate planing for those who wish to keep family businesses in the family after their death. The draconian approach exposed large portions of family businesses to 55 percent estate tax rates upon the death of the founder, in some cases forcing the liquidation of many businesses to pay the estate tax.

RRA repealed the estate-freeze provisions of section 2036(c) retroactive to the date of enactment. It permitted freezes and transfers of growth interests but provided new stringent valuation rules on the value of preferred stock retained by parents. The new rules, as complex as the old ones, are supposed to value transfers of assets for gift tax purposes more accurately by focusing on the value of property at the time of transfer instead of at the time of death. Contrary to the rule after December 17, 1987, once the value of transfers of interests is figured out, the transferred assets will not later be subject to taxation in the estate of the transferor. The provision is effective for transfers occurring after October 8, 1990.

The new law, although considered as good news for small businesses, raises some new obstacles. It forces heavy gift taxes on the portion of the business transferred to heirs at the time of the transfer therefore requiring large cash payments for typically a cashless transaction. The new valuation rule also raises concerns about how the Internal Revenue Service will interpret the law. The Agency reported that the new estate-freeze rules will be issued in the spring. In the mean time, estate planning itself seems to be frozen while many business owners are adopting a wait-and-see attitude. At the moment, the best advice, on estate freezes seems to be the one given by a family business owner, "Don't die."[10]

Conclusions

RRA raised the top marginal income tax rate from 28 percent to 31 percent. The bubble in the marginal tax rate has been shrunk. Tax liability for higher-income taxpayers has been increased through the increase in the top rate and the alternative minimum tax, the phaseout of the personal exemptions, and limitation on itemized deductions. Those in the bottom brackets received a significant increase in the refundable earned income tax credit. The largest tax increase will come from the increase in excise tax such as gasoline and from the hospital insurance tax on high-income workers. Few provisions affect the real estate industry directly. The capital gains tax rate was capped at 28 percent. The low-income housing credit and mortgage revenue bonds were extended. Significant changes in estate tax freezes were made. However, no major changes for tax-free exchange or passive loss rules were made.[11]

by

Orawin T. Velz
Tax Economist
Forecasting and Policy Analysis

Patrick W. Fleenor
Research Assistant

Endnotes

[1] For details of the bubble in the marginal tax rate under TRA, see Leavens (1990).

[2] See, for example, Grey (1990) and Godfrey (1990).

[3] See Cohen (1990).

[4] See Godfrey (1990) who gives examples of both winners and losers under RRA. For example, under TRA, the phased-out range of the personal exemptions for joint filers claiming four exemptions would be between the levels of taxable income of $160,000 and $205,000. Under RRA, such families would start losing their personal exemptions deduction sooner at the level of taxable income of $120,000 and would completely lose all the deduction at $235,000 of taxable income. Because the phase-out range is stretched longer under RRA, families between taxable incomes beyond the old phase-out range of $205,000 up until $235,000 would find themselves regaining some of the personal exemptions they lost under TRA.

[5] See Davis (1990) for other examples of how separate filing after 1990 will benefit some married couples.

[6] See Suwalsky, Jr. (1990), p. 251, quoting the number from the Bureau of the Census.

[7] The floor on itemized deduction differs from a simple tax increase in one important point: it is based on AGI rather than taxable income.

[8] For example, IRS data reported that 977 out of 65,303 taxpayers with AGI above $1 million did not itemize in 1988 and thus would experience no tax increase under this provision. An additional three or four percent of itemizers would also have a lower increase under this provision than a comparable rate increase because of the 80-percent exclusion factor. See Hoerner (1990).

[9] See Steuerle (1990) for details how a capital gains differential creates a complex situation among taxpayers and tax preparers.

[10] See Shellenbarger (1991).

[11] RRA modifies the $25,000 rental real estate deduction equivalent allowance allowed by TRA. Under the modification, the $200,000 to $250,000 AGI phaseout of the allowance is eliminated for purposes of the low-income housing tax credit. This modification is effective for property placed in service after 1989 where the taxpayer's interest in such property is also acquired after 1989.

References

Cohen, Edwin S. "Tax Policies and Political Positions," *Tax Notes*, December 31, 1990, pp. 1575-8.

Davis, Glen B., "Focus: Tax Planing," *Tax Management Weekly Report*, January 7, 1991, pp. 6-8.

Godfrey, "This Week's Tax News," *Tax Notes*, November 19, 1990, pp. 831-2.

Grey, Tim, "This Week's Tax News," *Tax Notes*, October 29, 1990, pp. 493-7.

Hoerner, J. Andrew, "This Week's Tax News," *Tax Notes*, October 29, 1990, pp. 498-500.

Leavens, Donald R., "Bubble Bathos," *Outlook*, NATIONAL ASSOCIATION OF REALTORS®, vol. 3, no. 11, November 1990, pp. 8-14.

Shellenbarger, Sue, "Law Reviving 'Estate Freezes' Creates New Frustrations: Entrepreneurs Wanting to Start Handing Down Firms Avoid Tactic for Now," the *Wall Street Journal*, January 11 , 1991, p. B2.

Steuerle, Gene, "Economic Perspective," *Tax Notes*, November 12, 1990, pp. 807-8.

Suwalsky, Jr., A.L., "The Revenue Reconciliation Act of 1990 and the Real Estate Industry," *Tax Management Real Estate Journal*, vol. 6, no. 12, December 5, 1990, pp. 250-3.

U.S. Economic Outlook: February 1991

Quarterly figures are seasonally adjusted annual rates

	90.3	90.4	91.1	91.2	91.3	91.4	92.1	92.2	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	1.4	-2.1	-1.8	-0.4	2.6	3.1	3.2	2.9	2.5	0.9	-0.2	2.7	2.4
Industrial Production	4.0	-8.0	-6.9	-3.5	1.2	3.8	4.4	4.9	2.6	1.0	-2.9	3.4	3.1
Civilian Employment	-1.3	-0.9	-1.3	-0.8	0.1	0.8	1.1	1.4	2.0	0.5	-0.7	0.9	1.3
GNP Inflation Index	3.7	2.8	3.5	2.9	2.8	2.4	2.8	2.5	4.1	4.1	3.2	2.7	2.7
Consumer Prices	6.4	6.9	4.1	2.7	3.5	3.5	3.6	3.5	4.8	5.4	4.5	3.5	3.3
Value of the U.S. Dollar	-20.7	-19.0	-1.9	-7.7	-1.4	-2.0	-3.1	-2.0	6.2	-9.6	-8.9	-2.1	1.2
Percent													
Mfg. Capacity Utilization	82.8	80.5	78.7	77.7	77.6	78.0	78.6	79.3	83.9	82.2	78.0	79.6	80.9
Civilian Unemployment	5.6	5.9	6.3	6.6	6.7	6.6	6.4	6.2	5.3	5.5	6.5	6.1	5.7
Percent of GNP													
Federal Tax Receipts	20.4	20.6	20.6	20.5	20.7	20.8	20.9	20.9	20.2	20.3	20.6	20.9	20.8
Federal Expenditures	23.1	23.6	23.7	23.8	23.6	23.6	23.6	23.3	22.8	23.3	23.7	23.3	23.0
Federal Budget Deficit	-2.6	-3.0	-3.1	-3.2	-2.9	-2.8	-2.7	-2.4	-2.6	-3.0	-3.0	-2.4	-2.3
Interest Rates, Percent													
Federal Funds Rate	8.2	7.7	6.6	6.3	6.5	6.7	7.0	6.9	9.2	8.1	6.6	7.0	7.2
3-Month T-Bill Rate	7.5	7.0	6.0	5.9	5.9	6.0	6.2	6.1	8.1	7.5	5.9	6.2	6.3
Prime Rate	10.0	10.0	9.1	9.0	9.0	9.2	9.5	9.5	10.9	10.0	9.1	9.5	9.5
Discount Rate	7.0	6.9	6.1	5.8	5.8	5.9	6.0	6.0	6.9	7.0	5.9	6.1	6.5
Corporate AAA Bond Yield	9.4	9.3	8.8	8.4	8.3	8.3	8.4	8.4	9.3	9.3	8.5	8.4	8.2
30-Year Government Bond Yield	8.8	8.5	8.1	7.7	7.7	7.8	7.9	7.9	8.4	8.6	7.8	7.9	7.8
Mortgage Rates, Percent													
30-Year Fixed Rate	10.1	10.0	9.3	9.1	9.0	9.0	9.0	8.9	10.3	10.1	9.1	8.9	8.8
1-Year Adjustable	8.4	8.1	7.8	7.5	7.4	7.4	7.4	7.5	9.3	8.4	7.5	7.5	7.5
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	4,164	3,904	3,824	3,941	4,074	4,212	4,326	4,467	4,446	4,182	4,013	4,473	4,626
Existing Single-Family Sales	3,333	3,140	3,085	3,163	3,240	3,333	3,415	3,517	3,467	3,304	3,205	3,523	3,681
New Single-Family Sales	524	478	472	483	498	519	537	551	654	534	493	556	594
Housing Starts	1,130	1,047	988	1,001	1,059	1,113	1,173	1,228	1,386	1,209	1,040	1,232	1,260
Single-Family Units	857	787	762	803	860	906	939	980	1,010	905	833	979	975
Multi-Family Units	273	259	226	198	199	207	234	249	377	303	208	253	285
2-4 Family Units	31	28	25	22	22	23	26	27	55	37	23	28	31
5+ Family Units	242	231	201	177	177	184	208	221	321	267	185	225	254
Mobile Homes Shipped	187	181	182	199	219	233	242	246	199	189	208	246	240
Percent change -- Year Ago													
Total Single-Family Sales	-5.5	-13.2	-14.5	-5.9	-2.2	7.9	13.1	13.3	-4.3	-5.9	-4.1	11.5	3.4
Existing Single-Family Sales	-3.2	-11.2	-9.9	-4.7	-2.8	6.1	10.7	11.2	-3.6	-4.7	-3.0	9.9	4.5
New Single-Family Sales	-25.0	-26.7	-20.3	-10.5	-5.0	8.6	13.8	14.1	-3.3	-18.4	-7.6	12.7	6.8
Housing Starts	-15.5	-22.3	-32.1	-16.8	-6.3	6.3	18.7	22.7	-7.0	-12.8	-14.0	18.4	2.3
Single-Family Units	-13.9	-20.3	-29.6	-10.3	0.3	15.0	23.2	22.0	-7.0	-10.3	-8.1	17.6	-0.5
Multi-Family Units	-20.2	-27.9	-39.1	-35.9	-27.2	-20.2	3.5	25.5	-7.1	-19.5	-31.6	21.8	12.9
2-4 Family Units	-44.6	-46.9	-43.0	-50.4	-29.8	-20.2	3.5	25.5	-5.7	-34.0	-38.0	21.8	12.9
5+ Family Units	-15.4	-24.6	-38.6	-33.5	-26.8	-20.2	3.5	25.5	-7.3	-16.9	-30.7	21.8	12.9
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.6	92.2	92.9	94.2	95.3	97.7	100.3	100.9	92.9	95.2	95.0	101.6	106.5
New Home Prices	116.7	124.3	121.9	122.6	123.6	125.7	127.1	129.1	120.4	122.7	123.4	130.2	137.1
Percent Change - Year Ago													
Existing Home Prices	1.8	-0.5	-3.2	-2.1	-1.4	5.9	8.0	7.1	4.2	2.5	-0.3	6.9	4.9
New Home Prices	-2.5	-0.1	-1.0	-3.2	5.9	1.1	4.3	5.3	6.2	1.9	0.6	5.5	5.3

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

REALTOR®

EQUAL HOUSING
OPPORTUNITY

A 7510 -1

REAL ESTATE

Vol. 4, No. 3

March 1991

OUTLOOK

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- The forces that were pushing the U.S. toward recession before the Persian Gulf crisis remain with us, even with oil prices below their pre-invasion levels and the Iraqis defeated. Consumer confidence fell precipitously last autumn as the U.S. braced itself for war and realized that it had stumbled into a recession. Reviving consumer confidence is an important requisite of economic recovery, but it's not the only one. Recovery depends upon such economic fundamentals as job growth, income gains, inflation and interest rates.

- Most of the available data suggests that the rebound has not begun yet but will arrive by mid-year. After declining 1.1 percent in the first half of 1991, the economy is expected to post a healthy 3.2 percent annual growth rate in the second half of 1991. Lower interest rates and lower inflation will make important contributions to reviving the economy.

- Despite last year's agricultural and energy price shocks, the inflationary spirals reminiscent of the 1970s have not shown up so far in the 1990s. Falling oil prices and the recession are playing an important role in restraining price increases. The Fed initiated another cut in its federal funds rate target, indicating the Fed thinks the economy and the fragile banking system need more help.

- Single-family dwellings accounted for most of the 12.8 percent decline in housing starts in January. The month's annual rate of 850,000 units is 45 percent below that recorded in January 1990, and represents the lowest level since January 1982. Among these troubling figures are some signs of recovery, especially lower mortgage rates and reviving consumer confidence.

- New home sales declined to 408,000 units in January, their lowest level since August of 1982. Anecdotal evidence indicates that the deterioration of sales in January is characteristic of the first half of the month. Increased traffic in the second half of January suggests that the seeds of a modest recovery in the housing sector have been planted.

IN THIS ISSUE

NATIONAL ASSOCIATION
OF REALTORS®
REALTOR®
The Voice for Real Estate™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991 NATIONAL ASSOCIATION OF REALTORS®

The Size of the Fight in the Dog

By John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

On the same day in February, spring training opened, James Brown was paroled and the war in the Persian Gulf ended. This is noted not to trivialize the war, but rather to point out how size, power and control are not always what they seem. And therein lies a tale for real estate in the Nineties.

We now know -- as we did not during the fighting -- how outnumbered coalition ground forces were in Kuwait. The Iraqi Army, fourth (oops, sixth; oops, tenth) largest in the world was nearly half against the size of the allies, and even that advantage was magnified by the fact that Iraq fought in the defensive. And while our technology and airpower were overwhelming, the ground forces were seemingly tabbed for massive losses in any attack.

That didn't happen by a long shot. It was averted by the adroit use of information by the allied forces to equalize size. Air attacks eliminated the ability of the Iraqis to "see" the battlefield, allowing three separate feints to persuade them of an amphibious landing that never came. The press (ironically, in light of the Vietnam experience) was used to mislead the Iraqis as to troop strengths. In short, the war was ultimately won through airpower, firepower, and *information power.*

Real estate centers completely around information. From MLS systems to mortgage lending terms, the value added by REALTORS® includes the provision of information to buyers and sellers so that they can make better decisions. But, information also has an impact on the success of the real estate firm.

Correctly used, it decides who will be the lead dog and who will be one of the pack. In a world of print and the leisurely spread of news, equality of information power was common. What did it matter what you knew and when you knew it if everyone had the same access? But that's not today's world. The war showed us how the instantaneous acquisition and processing of information has a real impact on reality. And differential access to information *is* reality.

* * *

It's fitting that spring training began as American victory was assured. Both bring vividly into mind the values that make this country great. But as baseball returns, we are reminded of the "impossible" World Series sweep of the targeted-for-defeat Cincinnati Reds last October. They simply *couldn't* win. The A's were more powerful; the A's had better pitching; the A's had momentum; the A's even had better looking families. But games are played on the field, not on paper, and the Reds did win.

Why? The stupid answer is that they scored more runs than the A's in each game. The more subtle response is that for a five day period in October, enough players wearing the Cincinnati uniform had career performances to assure that the underest of dogs prevailed.

Baseball can only be played with nine men at a time. If the A's had more quality talent, it only meant that they had a higher probability (not certainty) that some players would be playing well. But the nine the Reds put out consistently bettered the nine that Oakland played. Then, it didn't matter how many quality players sat on the benches; they never figured in the outcome.

Cincinnati won because it produced "size equivalency." Within the arena and within the terms of the game, it was as strong and as deep and as powerful as was Oakland. It wasn't the size of the dog in the fight here that mattered.

And thereby hangs a tale. The real estate business is very competitive, and the pressures on company costs will only make it more so in the future. Size and power are clearly an advantage, since market penetration and familiarity are often the only indicators the public goes on. But, smaller firms who have established reputations for service and expertise in well-defined sectors of the market can appear to be the equivalent of much larger firms.

That's really not a new concept; after all, it's one of the bases of the franchise movement. But, marry it with considerations about the use of information and some new guidelines develop.

One of the major changes in our society has been the hammering down of information costs and our increasing comfort with receiving more and more information from a variety of sources. This suggests the development of a clientele that will be impressed with the effective organization and presentation of facts and analysis that will further its decision process.

Here is the key to size equivalency. As the Nineties proceed, the premium placed on the timely provision of real estate market information will increase. Those who can access and organize that information will capture that premium and market success.

We are entering a decade in which the keys to profitability will more and more center around a computer screen and a fax machine. In that kind of world, where information is democratized, size is less a matter of the number of people or offices and more a matter of the skill with which the universal good -- information -- is manipulated.

* * *

Where does James Brown enter all this? Probably just as a device to note that the end of the war will likely coincide (when all the numbers are in) with the end of the recession. The burst of consumer confidence that accompanied the cease fire will bring the real estate market, and the entire economy, around by mid-year. As the Godfather of Soul sang on his release, so too does the American consumer: "I feeeel good!"

Outlook for the Economy and Real Estate

As the final straw to break the expansion's back, the Persian Gulf crisis has been tightly linked to the current recession. Now that the U.S. has orchestrated an overwhelming victory overseas, is the return of economic growth imminent? While a rebound in consumer confidence is widely anticipated, the recovery is expected to lag behind by a few months. The NAR forecast calls for a 2.4 percent annual rate of decline in 1991's first quarter and slight growth of 0.2 percent in the second quarter. By mid-year a recovery will be in place, and growth will pick up to a 3.2 percent rate in the year's second half.

The Roots of the Recession

The Persian Gulf crisis can only be said to be a contributor to the recession, not the cause. Housing starts, consumer confidence, corporate profits, and growth in real personal income were all sliding before the Iraqi invasion of Kuwait. Inflation had remained fairly stubborn in the face of two years of monetary tightening designed to eliminate it, and purchasing power was eroding. Moreover, manufacturing firms were struggling, with job losses recorded in sixteen of the eighteen months between February 1989 and July 1990. On net, 406,000 manufacturing workers lost their jobs during this period. Meanwhile, the S&L bailout added billions to the federal budget deficit, and the embattled American president broke his most prominent campaign pledge in June by placing tax increases on the budget negotiating table. In sum, there were powerful forces pushing the U.S. toward recession well before the events of August 2.

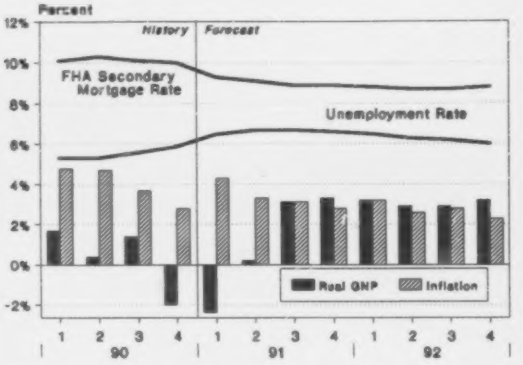
Many of these forces remain with us, even with oil prices below their pre-invasion levels and the Iraqis defeated. Just as the downturn wasn't caused soley by Saddam, his defeat alone won't spell relief from the recession. It's an important roadblock removed, but recovery depends on such economic fundamentals as job growth, income gains and interest rates. Most of these indicators suggest not an immediate recovery but a rebound by mid-year.

The Consumers' Diet

The slowdown in consumer spending predates the summer of 1990. The chart at right shows just how much consumers cut back in the past two years relative to the 1983-89 expansion averages. During 1989-90, total spending grew at only a 0.7 annual rate, only one-fifth of its annual average of 3.6 percent during most of the Eighties. Purchases of durables, goods which are expected to last at least three years, climbed at a 7.1 percent annual average during the expansion but fell at a 1.4 percent rate in 1989-90. Clearly, consumers were feeling the squeeze of higher inflation, higher debt levels, higher expected taxes, and slower job growth. These concerns have not disappeared with the decimation of the Iraqi Republican Guard.

Much attention has been paid to consumer confidence, which fell precipitously last autumn as the U.S. both braced itself for war and realized that it had stumbled into a recession. With consumer expenditures making up two-thirds of total demand, its 2.9 percent decline during the fourth quarter was a critical drag on the economy. Another decline is expected in the current quarter. Reviv-

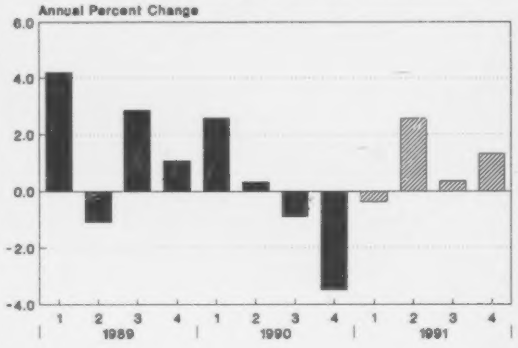
The Economic Outlook



Sources: Bureau of Economic Analysis; NAR forecast

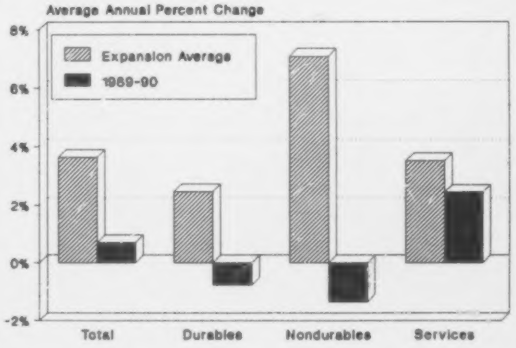
Eroding Purchasing Power

Change in Real Disposable Personal Income



Source: Bureau of Economic Analysis

Drop in Consumption Expenditures Isn't New



Source: Bureau of Economic Analysis

ing consumer confidence is an important requisite of the recovery, but it's not the only one. Consumers spend income, not confidence, and it's not until more income is generated that a solid recovery will take root.

In terms of job growth, it appears that the recession remained very much with us during February. Another 184,000 jobs were lost during the month, and the unemployment rate rose to 6.5 percent from 6.2 percent. Over the past seven months, payrolls have been cut by over a million jobs, not including some auto industry layoffs, which were announced after the employment survey was complete. Bearing the brunt of the reduction has been manufacturing and construction, but services have been vulnerable as well.

Inventories Suggest Recession to Remain Mild

Inventories are playing a peculiar role during the current recession -- a role which supports the case for a mild recession. Typically, unsold merchandise stacks up at the beginning of a recession as demand (usually termed final sales) dwindles. In response, businesses slash production, reduce employment and sell out of inventories until sales revive. But in the first full quarter of the current recession, inventories *fell* by a steep $22.2 billion and final sales eeked out a small gain of 0.6 percent. Without the typical inventory build-up, the deep production cuts usually seen may be avoided during the current recession. Perhaps with the exception of the auto industry, inventories remain well under control, augering well for a recovery by mid-year.

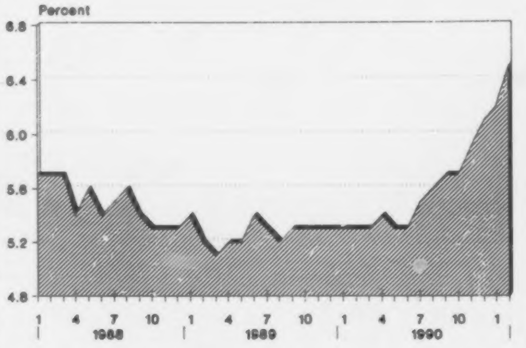
Recession's Silver Lining: Reduced Inflation

Inflation appears to be another bright spot. Despite last year's agricultural and energy price shocks, the inflationary spirals reminiscent of the 1970s have not shown up so far in the 1990s. One sign of this is the subdued increase in average hourly earnings. The chart to the right shows how wage growth appears to be decelerating relative to the annual averages of the 1970s and 1980s. And relief is apparent in consumer prices as well. After increasing [illegible] 6.3 percent rate from the end of 1989 to the end of 1[illegible] the consumer price index is expected to post a 3.3 perc[illegible] gain by the end of 1991. Falling oil prices and the recession are playing an important role in restraining price increases.

This relatively tame rate of inflation gives the Federal Reserve some additional room to ease. As it did last month, the Fed initiated another cut in its federal funds rate target when the employment figures were released. If the Fed thought the economy had reached bottom, the cut probably would not have come, and the Fed would have waited for additional data to confirm their suspicions about a rebound. But apparently the Fed thinks the economy needs more help. Of course, too much monetary stimulus means additional inflation ahead, and it's inflation that the Fed has sought to fight over the past couple of years with its policy of monetary restraint. The 1988-90 episode of tightening is seen in the chart at right, which also shows the modest increase in reserve growth anticipated in 1991.

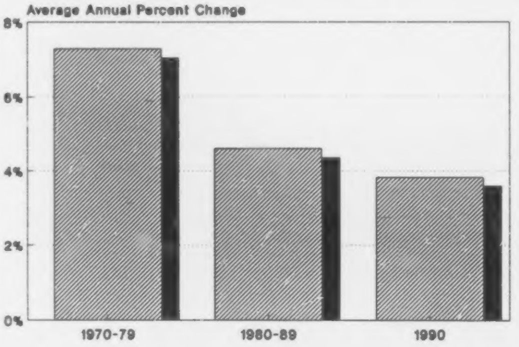
In addition to easing credit policy to end the recession, the Fed is also interested in reducing the pressure on the banking system's wobbly financial structure. Lower rates will take some bite out of the credit crunch, freeing up funds for lending.

Unemployment Rate Rises



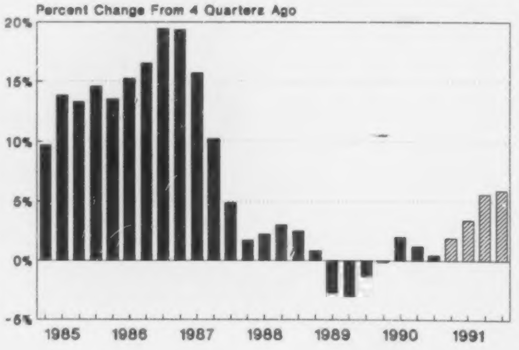
Source: Bureau of Labor Statistics

The Wage-Price Spiral Seems Unwound
Growth in Average Weekly Earnings



Source: Bureau of Labor Statistics

The Fed's Monetary Spigot
Growth in Nonborrowed Bank Reserves



Source: Federal Reserve Board

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

	Total	SF	2-4	5+
Jan 1990	1,543	1,078	53	412
Sep 1990	1,106	858	35	213
Oct 1990	1,026	839	22	165
Nov 1990	1,130	769	54	307
Dec 1990	975	749	17	209
Jan 1991	***850***	***632***	***29***	***189***
Annual Averages:				
1989	1,381	1,005	56	320
1990	1,203	901	37	265
Percent Changes in January 1991 since:				
Jan 1990	-44.9	-41.4	-45.3	-54.1
Dec 1990	-12.8	-15.6	70.6	-9.6

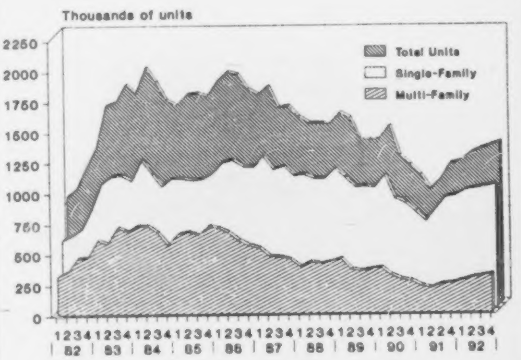
Regional Data

	Northeast	Midwest	South	West
Jan 1990	158	364	522	499
Sep 1990	104	239	445	318
Oct 1990	144	230	392	260
Nov 1990	147	232	483	268
Dec 1990	109	233	400	233
Jan 1991	***77***	***198***	***340***	***235***
Annual Averages:				
1989	181	269	535	397
1990	135	259	479	330
Percent Changes in January 1991 since:				
Jan 1990	-51.3	-45.6	-34.9	-52.9
Dec 1990	-29.4	-15.0	-15.0	0.9

Source: Bureau of the Census; Construction Reports, Series C20

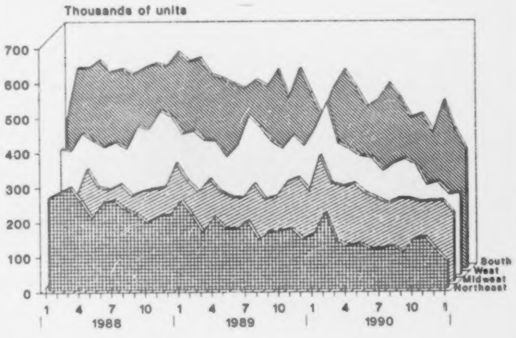
Source: Bureau of Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of Census

The inability of home builders to obtain financing coupled with weakened consumer confidence helps to explain the sharp 12.8 percent drop in housing starts in January. The month's annual rate of 850,000 units is 45 percent below that recorded in January 1990, and represents the lowest level since January 1982. Single-family starts accounted for most of the decline, falling 15.6 percent from December to a rate of 632,000 units

Starts in the Northeast dropped 29 percent, to a rate of 77,000 units a year. The Midwest and South had 15 percent declines, to 198,000 and 340,000 respectively, while the West posted a modest advance to 235,000 units.

Among these troubling figures are some signs of recovery. As early as the second quarter of 1991, lower interest rates and a restoration of consumer confidence are expected to revitalize the demand for housing. Single-family starts will be more responsive to these forces, adding nearly 100,000 units to reach 808,000 units in the second quarter. On the multifamily side, the subtle credit tightening occurring in the home loan industry is making loan approvals more difficult to secure. This will restrict multifamily growth until the third quarter of 1991, when starts are expected to advance by 35,000 units to 237,000 units.

Growth in housing should be well under way by the second half of 1991. Multifamily starts are expected to increase nearly 30 percent in 1992, and single-family starts are projected to expand 18 percent.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

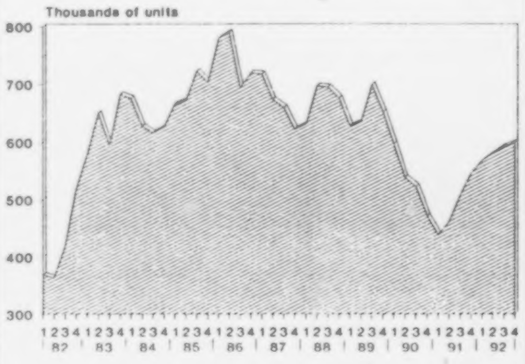
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jan 1990	627	-0.9	-10.9
Feb 1990	606	-3.3	-2.7
Mar 1990	559	-7.8	0.5
Apr 1990	534	-4.5	-12.5
May 1990	535	0.2	-17.8
Jun 1990	549	2.6	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	486	4.5	-29.3
Dec 1990	465	-4.3	-26.5
Jan 1991	***408***	***-12.3***	***-34.9***
Annual Averages:			
1989	654		-3.3
1990	533		-18.3

Regional Data

	Northeast	Midwest	South	West
Jan 1990	99	106	235	187
Jul 1990	72	92	237	140
Aug 1990	63	88	236	138
Sep 1990	61	93	215	134
Oct 1990	74	70	209	113
Nov 1990	69	86	208	123
Dec 1990	65	86	194	119
Jan 1991	***57***	***74***	***160***	***117***
Annual Averages:				
1989	90	103	258	202
1990	74	90	223	146
Percent Changes in January 1991 since:				
Jan 1990	-42.4	-30.2	-31.9	-37.4
Dec 1990	-12.3	-14.0	-17.5	-1.7

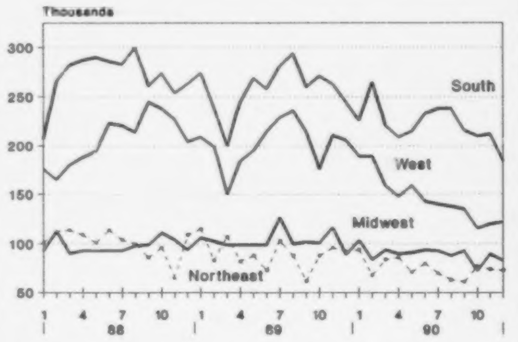
Source: Bureau of Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of Census

New home sales declined by 12.3 percent in January as the war in the Persian Gulf and the recession intensified. Sales of new homes dropped 57,000 units to 408,000 units, their lowest level since August of 1982. Sales in Janaury were only two-thirds of the pace set in January, 1990.

By region, the South recorded the steepest drop with sales falling by 17.5 percent to an annual rate of 160,000 units. In the Midwest, sales fell 14 percent to 74,000 units after exhibiting no growth the previous month. Sales dropped 12.3 percent, to 57,000 units, in the Northeast. In the West, sales dropped 1.7 percent to 117,000 units.

Anecdotal evidence indicates that the deterioration of sales in January is characteristic of the first half of the month. Activity during the second half of the month hinted at a renewed interest in homebuying, perhaps in relief that the Gulf War had begun and was going so well for the U.S. The increased traffic suggests that the seeds of a modest recovery in the housing sector have been planted.

Favorable financing conditions are expected to rekindle the demand for new homes, which will be evident by the second quarter of 1991. Sales are projected to increase 5 percent to 462,000 units during the second quarter of 1991, and growth will accelerate by midyear, as sales increase by 10 percent and 7 percent in the third and fourth quarters of 1991, respectively. Sales are expected to increase by almost 20 percent in 1992.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

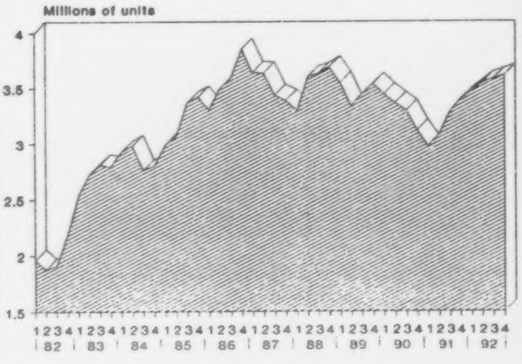
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jan 1990	3,470	-2.5	-5.2
Feb 1990	3,420	-1.4	-3.7
Mar 1990	3,440	0.6	0.3
Apr 1990	3,370	-2.0	-2.0
May 1990	3,350	-0.6	3.1
Jun 1990	3,370	0.6	1.2
Jul 1990	3,320	-1.5	-1.8
Aug 1990	3,410	2.7	-0.9
Sep 1990	3,160	-7.3	-10.0
Oct 1990	3,070	-2.8	-12.0
Nov 1990	3,150	2.6	-11.5
Dec 1990	3,130	-0.6	-12.1
Jan 1991	***2,910***	***-7.0***	***-16.1***
Annual Averages:			
1989	3,467		-2.5
1990	3,305		-4.7

Regional Data

	Northeast	Midwest	South	West
Jan 1990	570	940	1,380	580
Aug 1990	520	930	1,380	570
Sep 1990	520	880	1,240	520
Oct 1990	500	820	1,240	500
Nov 1990	500	860	1,280	500
Dec 1990	500	880	1,260	490
Jan 1991	***460***	***810***	***1,180***	***470***
Annual Averages:				
1989	597	931	1,320	617
1990	523	908	1,310	558
Percent changes in January 1991 since:				
Jan 1990	-19.3	-13.8	-14.5	-19.0
Dec 1990	-8.0	-8.0	-6.3	-4.1

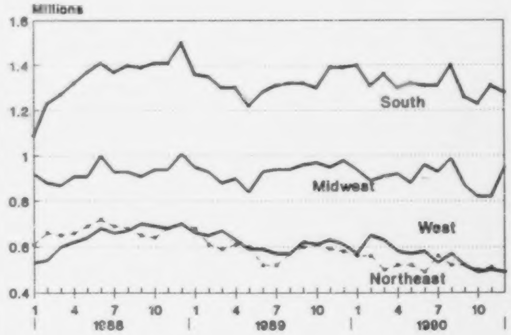
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

Favorable financing conditions in January were not enough to overcome consumers' preoccupation with the events in the Persian Gulf. Sales of existing single-family homes declined by 7 percent from December, dropping to 2,910,000 units. This represents a 16 percent decline from the year-ago figure.

The decline in existing home sales between December and January was spread evenly among the regions. The Midwest, which has shown the greatest resistance to the recession so far, was affected by harsh weather in January. Sales in the region declined by 8 percent from December, to 810,000 units. In the Northeast, existing homes were sold at a rate of 460,000 units, down 8 percent. The South recorded a resale pace of 1.18 million units, down 6.3 percent. Sales in the West fell by 4.1 percent from December's level of 490,000 units to 470,000 units.

Despite these widespread declines, anecdotal information from REALTORS® across the country indicates that activity started to increase at the end of January. February sales are expected to be up, and by late spring favorable mortgage rates should produce a noticeably larger volume of purchases. Sales ~~are~~ projected to increase by 3.6 percent in the second quarter of 1991, and the sales pace is expected to accelerate as the year continues. By the fourth quarter, sales are projected to be 424,000 units above the first quarter level. Sales will build upon this healthy pace during 1992, when sales are expected to increase by 11.5 percent.

Single-Family Home Prices

(In Dollars)

National Data

	Median		Average	
	Existing	New	Existing	New
Jan 1990	95,200	125,000	120,000	151,700
Aug 1990	97,200	118,400	120,500	144,700
Sep 1990	94,400	113,000	116,700	142,100
Oct 1990	92,900	120,000	115,900	153,000
Nov 1990	92,000	118,900	115,500	143,600
Dec 1990	91,700	126,900	114,100	152,200
Jan 1991	***94,200***	***121,800***	***121,500***	***156,200***
Annual Averages:				
1989	92,900	120,400	118,000	148,300
1990	95,200	122,100	118,300	148,900
Percent changes in January 1991 since:				
Jan 1990	-1.1	-2.6	1.3	3.0
Dec 1990	2.7	-4.0	6.5	2.6

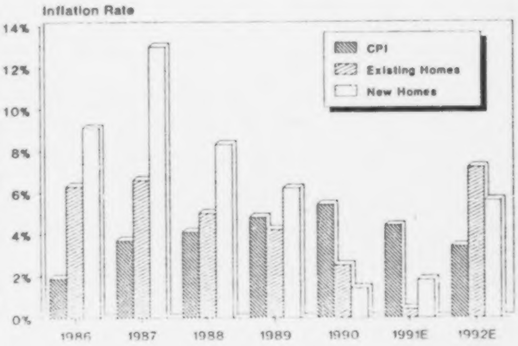
Regional Data

Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Jan 1990	143,400	72,200	85,200	147,000
Aug 1990	145,300	75,300	86,900	140,200
Sep 1990	137,100	74,200	85,900	134,700
Oct 1990	136,200	72,000	83,200	142,000
Nov 1990	134,200	71,400	83,500	139,700
Dec 1990	134,400	72,300	82,800	131,400
Jan 1991	***136,900***	***74,500***	***84,300***	***138,200***
Annual Averages:				
1989	145,100	71,200	84,400	139,800
1990	141,700	73,800	85,500	139,800
Percent changes in January 1991 since:				
Jan 1990	-4.5	3.2	-1.1	-6.0
Dec 1990	1.9	3.0	1.8	5.2

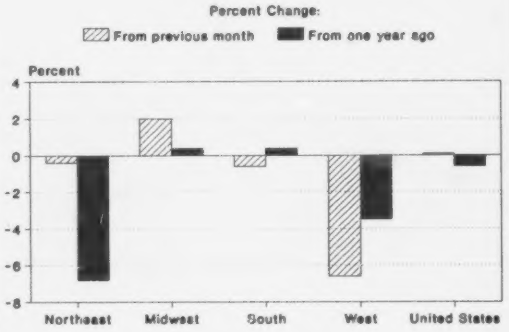
Source: National Association of Realtors,® "Home Sales"

Home Prices



Source: Bureau of Census; E Real Estate Outlook forecast

Home Prices by Region



Source: NAR Economics & Research

The national median existing single-family home price increased from $91,700 in December to $94,200 in January. The 2.7 percent increase probably reflects the concentration of higher-priced home sales, as the post-holiday market tends to consist of more affluent buyers.

In the market for new homes, the median price declined 4 percent to $121,800 in January. This slowdown reflects the growth of new-home inventories, which stands at its highest level since April of 1982.

The average price of both existing and new single-family homes increased in January. An increase of 6.5 percent added $7,400 to the price of an existing single-family home. New home prices grew by 2.6 percent, bringing the average price of a new single-family home to $156,200.

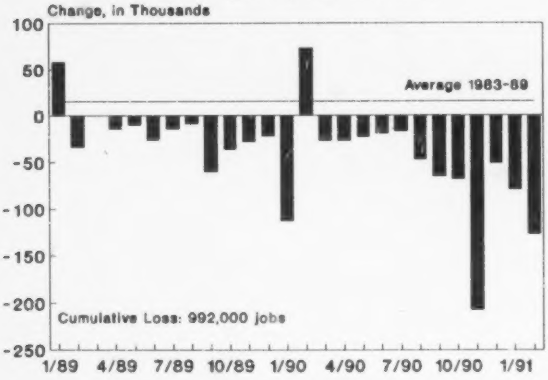
Modest appreciation in the median price of existing single-family homes is expected over the next year, with an increase of 0.4 percent in 1991. Prices will begin to firm at year end and are projected to increase by 7.2 percent in 1992. New single-family home prices should experience slightly higher growth in 1991, with prices increasing by 1.8 percent. In 1992 the median price of new single-family homes will increase by 5.6 percent.

Robert D. Barr *Kimberly A. Martin*
Director of Forecasting *Research Economist*
Forecasting & Policy Analysis

The Keys to the Coming Recovery

The signs of recession are numerous: Housing starts seemingly hit bottom -- until the next month's report shows another decline. Sales of new homes are only two-thirds of last year's rate, and January's pace is the slowest since 1982. Existing home sales are not faring much better, with sales down 16 percent over last year. Meanwhile, the labor markets continue to sink as another 184,000 workers lose jobs in February and the unemployment rate reaches 6.5 percent. Consumer confidence in recent months has reached record lows, and the government's economic weathervane, the Index of Leading Economic Indicators, has pointed down for six consecutive months. How, then, can one find a recovery ahead when all seems to be gloom?

Manufacturing Employment Drops



As discussed in the Outlook article on pages 2-3, confidence in a recovery is not necessarily related to the U.S.'s resounding success in the Persian Gulf. The resolution of the crisis suggests that oil prices will remain fairly tame and lightens the burden of uncertainty from consumers and businesses. This will contribute very importantly to America's recovery, but will not by itself propel the economy to recovery. The recession was largely a result of economic forces unleashed here in the states, not military forces unleashed in the Gulf. Any recovery must overcome these economic fundamentals, which cannot be washed away in a flood of renewed confidence.

There's plenty to suggest that the recession may drag on through the end of 1991, but, on the other hand, there's also some reason to think that March could mark the recession's end, once all the figures are available. On balance, however, the evidence suggests that recovery will take hold by mid-year, leaving in its wake only a relatively mild and short recession. While the current forecast calls for growth in the second quarter, the annual rate is so small -- 0.2 percent -- that we look to the third quarter's 3.1 percent rate as the first full quarter of recovery.

This article will briefly discuss the recovery phase of the typical business cycle and then look at several key areas of the economy which are flashing the green lights necessary to allow the economy to get its wheels turning again.

What We Can Expect: Lessons From Previous Recoveries

Generally speaking, recessions occur as businesses and consumers cut back on debt accumulation after going through a period of debt expansion. Consumers borrow to purchase homes, cars and vacations; businesses borrow to expand or purchase existing businesses. At some point, given current interest rates, inflation rates and income growth, the debt burden becomes too heavy. If it's sufficiently widespread, the resulting retrenchment leads to a recession.

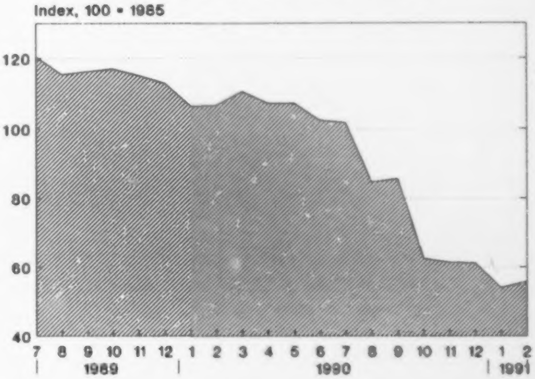
The seeds of the next recovery are planted during the preceding recession, which gives consumers and businesses time for a breather. Inflation and interest rates fall, and those who feel confident in maintaining their income level despite the recession are in position to take advantage of the lower interest rates, and so increase their spending. Meanwhile, reduced production improves labor productivity, which lowers the cost per unit of each good. Coupled with lower borrowing rates, the lower unit labor costs improve businesses' ability to expand.

The government plays an important role in the determination of the timing and duration of business cycles, particularly through its monetary policy. Consequently, the Federal Reserve's handling of credit policy is generally at the center of any story about recession and recovery.

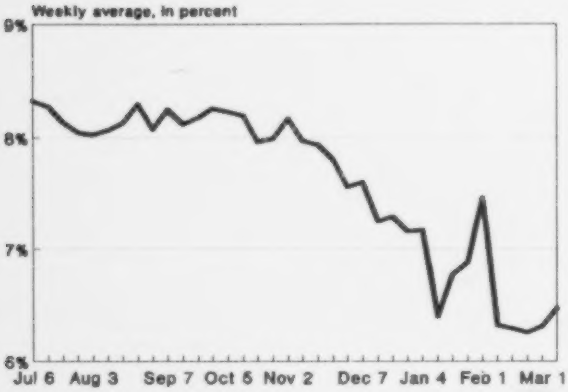
Five Keys to Recovery

Federal Reserve Policy. The first key is the monetary policy pursued by the Fed, and this is most clearly seen in the so-called fed funds market. It's here that banks make overnight loans to other banks who are experiencing

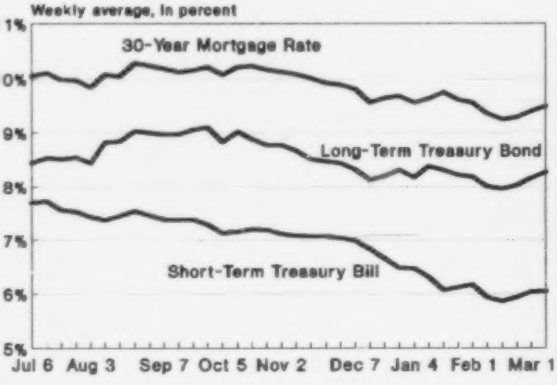
Consumer Confidence Plummets, But Recovery Starts in February



The Fed Pushes Down on the Fed Funds Rate. . .



. . .And Other Rates Drift Down



shortfalls in their required reserves. The rate charged is influenced by the Fed as it adds or drains reserves in the banking system through its daily operations. In acknowledgement of worsening economic conditions, the Fed has lowered its target range for the fed funds rate in the past few months, and consequently the market rate has fallen about 2 percentage points, as shown in the chart above. The current target rate of 6.0 percent was adopted on March 8, when the government released February's dismal employment report.

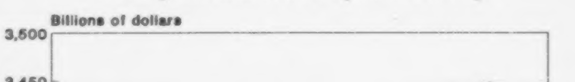
The lower fed funds rate generally translates into lower rates elsewhere in the banking system and enables banks to make more loans. This should then result in an increase in the money supply. There had been concern that the Fed's easing wasn't having its desired effect since money growth, as measured by the aggregate M2, had been so anemic in the fall and early winter (see chart below). But M2 growth finally perked up in February, according to preliminary figures. This is a signal of increased lending and, perhaps, a signal that consumers are ready to reach for their wallets once again.

In addition to lowering the fed funds target rate, the Fed pulled its two other policy levers at the end of 1990. First, the discount rate, the rate at which banks can borrow from the Fed, was cut twice by a half-point to bring it to 6 percent (it had been at 7 percent for nearly two years). According to some reports, the Fed also encouraged banks to make greater use of the discount window. Banks had been avoiding borrowing from the Fed since such moves were often seen by the market as a signal of problems at the bank. With confidence such an integral asset in a bank's survival, the higher rates charged in the fed funds market were often preferable to going to the Fed. Second, a rare and significant move towards easing the credit crunch came in December when the Fed lowered reserve requirements. This reduction, the first since 1983, freed up $13 billion in reserves and will aid bank profitability. It is countered, however, by January's increase in FDIC premiums.

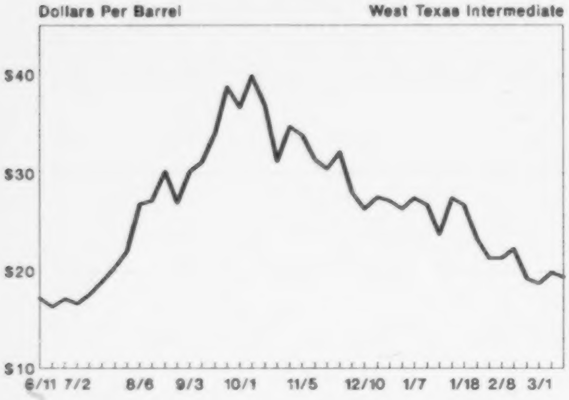
Inflation. While tight monetary policy may have pushed us close to a recession in the past couple of years, it has also kept the underlying inflation rate close to 4 percent -- not great, but far more manageable than the 12 percent rate preceding the 1981-82 recession. While special factors -- agricultural difficulties, the oil price shock, and increased excise taxes -- pushed inflation over 6 percent during 1990, inflation will probably remain subdued in coming quarters. A given increase in income means more purchasing power as inflation falls, and it's this improvement that generates the more economically fundamental boost in consumer confidence.

Inventories. As noted in the Outlook article, inven-

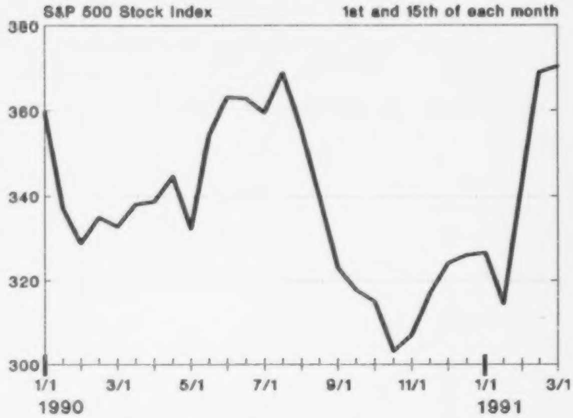
Money Growth Perks Up in February



Oil Prices Retreat, Bring Inflation Relief in '91



The Stock Market Signals Go



tories are playing a role which suggests that the big production cuts normally associated with recessions are not ahead of us. In fact, it appears that the cuts in production, and the concomitant loss of jobs, occured in advance of the recession as the economy slowed during 1989 and 1990. The lean inventories seen in most industries suggests that the worst of the manufacturing job losses are behind us.

Corporate Profits. The first quarter of 1991 is expected to be the seventh quarter in the last nine that profits have fallen, but big increases are expected in the second half of this year and into 1992. One widely recognized sign that the recovery will be upon us within four to six months is the stock market, which is an indicator of corporate America's health. While it tends to predict recessions when the economy is merely slowing down, the stock market has a strong record in signaling oncoming recoveries.

Housing. Anecdotal evidence from REALTORS® and surveys conducted by other housing trade associations show that the housing market may have turned the corner. Traffic appears to be up for both new and existing homes as buyers attempt to take advantage of soft prices and lower mortgage rates. This suggests an increased willingness on the part of consumers to make the financial stretch usually required to purchase new housing. This sense of confidence could only exist if these potential homebuyers felt secure in their jobs and income levels.

Other Contributors to the Recovery

There are other, scattered reports that the recession may be bottoming out soon. Many of these reports are preliminary, and there's a good chance that the positive changes will be reversed in upcoming months. Nevertheless, they add some insight into the depth of the recession.

For example, the Index of Leading Economic Indicators has declined for six consecutive months, as mentioned earlier. Yet the declines in December (-0.1 percent) and January (-0.4 percent) were substantially smaller than the previous four declines, which averaged just over 1.0 percent. Further, two components of the index, the stock market and the money supply, have already recorded sharp gains in February, suggesting that the overall index will rise in February.

Exports performed well in the second half of 1990, expanding at a 7.0 percent annual rate. They moderated the beginning of the downturn and were thought to be a major source of strength in 1991. While exports will continue to grow, their expected contribution has been trimmed considerably due to overseas recessions and expectations that the dollar may appreciate over the next several quarters, following its sharp appreciation during February. Exports are expected to grow about 3.5 percent in 1991, down from 1990's 6.2 percent performance.

Another mixed indicator that still shows signs of snapping back is durable goods orders. They plunged 10 percent in November but rose 3 percent in December. January saw orders fall again, but this time only by 1.8 percent. This pattern is more consistent with a business cycle near its trough rather than one with more massive declines in store.

Finally, preliminary figures for retail sales show a healthy rebound in February, with a strong gain in durable goods leading total sales to advance at a 9.7 percent annual rate.

By Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis

Sources: Employment Data -- Bureau of Labor Statistics; Consumer Confidence Index -- The Conference Board; Interest Rates and Money Supply -- Federal Reserve Board; Oil Prices -- DRI, Inc.; S&P 500 -- Wall Street Journal.

ON THE PRESIDENT'S 1992 BUDGET: DEFICIT, DEBT, AND PROPOSALS AFFECTING REAL ESTATE

On February 4, the President sent his budget to Congress proposing record spending of $1.446 trillion and forecasting revenue of $1.165 trillion for fiscal 1992 ending September 30, 1992. These spending numbers are considered optimistic since they do not include the cost of Operation Desert Storm.[1] Most of the President's proposals are virtually the same as those he submitted last year. With the deficit topping $300 billion this year, there is little room for big spending programs. The President continues to seek a capital gains tax cut, penalty-free withdrawals from Individual Retirement Accounts (IRAs) for first-time homebuyers, and enterprise zones. He also proposed to extend for one year a number of expiring provisions such as the low-income housing tax credit and health insurance deduction for self-employed individuals.

The Deficit Projection

The federal budget has not been balanced since 1969. The President's budget proposals project the largest deficits in U.S. history -- $318.1 billion in the current fiscal year and $280.9 billion in fiscal 1992.[2] The federal budget continues to be encumbered in the short term by the costs of the savings and loan bailout, which are expected to be relatively high compared to other spending programs in the budget. For example, for fiscal 1991, the expected costs of covering deposit insurance losses totalling $112 billion are far greater than the combined actual budgets of the Departments of Education, Housing and Urban Development (HUD), Transportation, and Veterans Affairs which in fiscal 1990 totalled $101 billion.

According to the Office of Management and Budget (OMB), an agency that keeps tabs of the Administration's budget, however, deposit insurance costs will decline rapidly after fiscal 1992. In the longer term, the disposition of assets the government has acquired from failed savings and loan institutions will bring in more revenue, making significant contributions to reducing the deficit. For example, in fiscal 1995 when the deficit is projected to be only $3 billion, the deposit insurance programs are expected to bring in $42 billion of revenue, a large swing from the $112 billion costs incurred in this fiscal year. The Administration's forecasts of rapidly falling deficits in the longer term also rest on the assumption that the economy would quickly strengthen and remain strong through 1996.

Figure 1
Total Federal Deficit, 1984-1996
Actual and Forecast in the 1992 Budget

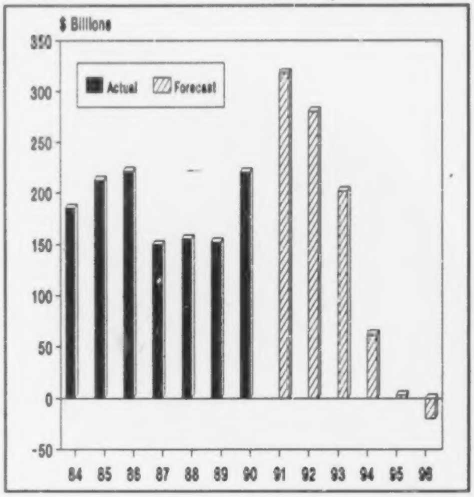


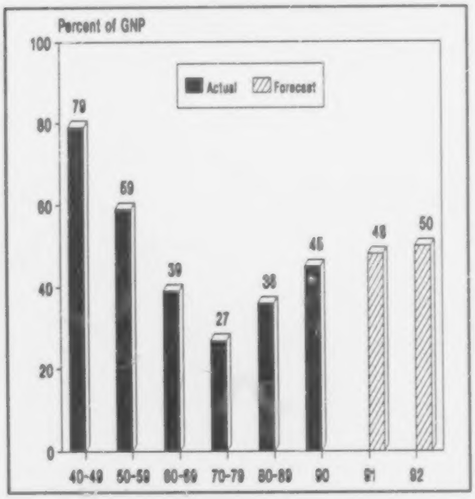
Figure 1 shows the historical data on the actual deficit from fiscal 1984 to 1990 and the projected deficit from 1991 to 1996. Following the record-high projected deficit of this year and next year, the projected deficit is nearly eliminated by fiscal 1995 and the budget is in surplus in fiscal 1996.

The Public Debt Limit and the President's Proposal

The Omnibus Reconciliation Act of 1990 (OBRA), passed last November, increased the permanent limit on the debt by roughly $1 trillion, to $4.145 trillion. The debt outstanding subject to the limit in late February 1991 was approximately $3.35 trillion.[3] Therefore, there is unused debt authority to accommodate future projected deficits.

Figure 2 shows the federal debt held by the public at the end of fiscal year as a percent of gross national product (GNP) by decade from 1940 to 1992.[4] The average public debt-GNP ratio was as high as 79 percent during the 1940s and as low as 27 percent during the 1970s. At one point, the ratio was as low as 24.3 percent in 1974 and never exceeded 40 percent between 1965 and 1985. The projected public debt-GNP ratio for fiscal 1991 is 48.4 percent, a proportion not seen since 1958.

Figure 2
Federal Debt Held by the Public
as Percent of GNP, 1940-1992
Actual and Forecast in the 1992 Budget



New Budget Process Built into the 1990 Act

OBRA made broad changes to the rules of the budget process that will affect future tax legislation. The Gramm-Rudman-Hollings rules (GRH) are no longer a constraint on the budget process. The goal of GRH was to reduce the federal budget deficit in gradual steps until it was eliminated in fiscal 1993. The slow economy coupled with the substantial costs of the savings and loan bailout made it impossible to obtain the GRH targets for last year. Under new budget rules, Congress is no longer forced to meet fixed deficit targets. Thus, higher deficits that result from recession, war, or bank failures will not require offsetting tax increases or spending cuts for the purpose of meeting a predetermined deficit target.

The new budget process rules include two new spending limitation mechanisms, which replace GRH rules: caps for discretionary spending and a pay-as-you-go rule for entitlement spending and revenue legislation. Between 1991 and 1993, limits or caps have been placed on discretionary spending (appropriations) in three categories -- defense, international, and domestic programs other than entitlement programs. The caps for fiscal 1994 and 1995 apply to the aggregate of these three categories. If discretionary spending in any of the three categories exceeds the cap of that category, a sequestration will occur to all programs in that category by whatever percentage is needed to reach the cap. Unlike previous law which allowed a tax increase to pay for legislation that increased discretionary spending, this new rule prevents the government from increasing appropriations beyond the limit even if tax revenue can be raised to offset such increases. Any additional military spending required in connection with the Gulf war, however, would not be subject to the cap on defense spending.

The other budget rule, known as the pay-as-you-go provision, requires that the deficit not be increased because of newly-enacted legislation that affects tax revenues or entitlement spending. That is, the aggregate of legislated changes in revenues for a year, when added to the aggregate of legislated changes in entitlement spending for the year, cannot increase the deficit. If such changes in tax revenue or entitlement spending increase the deficit, certain entitlement programs may be sequestered or tax revenues may be raised to offset such increases. For example, a revenue loss resulting from legislating new or expanding tax incentives could be matched with base-broadening provisions that raise revenues or a mandatory program cut. There are exceptions, however, to this rule. For example, an increase in entitlement spending, such as Medicare, as a result of new legislation must be offset with revenue increases or mandatory spending reductions. However, an increase in Medicare spending attributable to higher-than-expected inflation or lower-than-expected growth would not require a spending cut or a tax increase.

Financing the President's Budget According to the New Budget Process and New Scorekeeping Rules

The President's budget meets the spending caps for discretionary spending. To offset revenue losses from his tax proposals -- ranging from extension of expiring provisions to newly-proposed legislation such as enterprise zones -- the President proposes revenue raisers in the budget including the extension of medicare taxes to all state and local employees, an increase in the Internal Revenue Service enforcement funding, and various new or increased user fees. Furthermore, the President once again scored his proposal to cut the tax rate on capital gains as a revenue-gainer.

To accommodate partisan differences on capital gains, however, the President's budget contains two bottom line estimates for the tax proposals: one counts capital gains as a revenue-gainer; the other omits it. Counting capital gains, the President's tax proposals would lose $2.6

billion from 1992 through 1996. Without capital gains, they would lose $11.7 billion during the same period. The Administration's estimate of a $9.1 billion revenue increase as a result of a capital gains rate cut substantially differs from the Joint Tax Committee's recent estimate that cutting the capital gains rate would lose $10.6 billion over five years.

Under OBRA's budget scorekeeping rules, OMB has the final authority after legislation has been enacted to estimate the legislation's budget effect. The House, however, has amended its rules to provide that Congressional estimates must be incorporated in the statutory language of certain legislation, including any revenue legislation. However, a similar provision has not been adopted by the Senate, and the President has indicated that he would veto any tax or other legislation containing Congressional estimates. The outcome of the conflict between Congress and the Administration on the budget scorekeeping rule will have an important implication with respect to the capital gains issue. If OMB estimates prevail, a capital gains reduction could provide revenue to pay for other revenue-losing provisions in the budget. On the other hand, if Congressional estimates prevail, other sources of revenue could be necessary to offset the revenue loss from the capital gains rate cut.

The Capital Gains Proposal

To resolve a controversy over revenues from his capital gains proposal, the President has called for a study of capital gains estimates by a bipartisan commission chaired by the Federal Reserve Chairman Alan Greenspan. The President hopes that a technical study from an independent group would resolve the political and technical controversies currently clouding the capital gains rate issue.

As he spoke to the Banking Committee following his semi-annual report to Congress on monetary policy, the Fed Chairman reiterated his stance that the current capital gains tax should not be just reduced, but rather eliminated if the nation is to foster increased investment and economic growth. The tax on capital gains, he argued, raises revenue at the expense of investment incentives and growth.

The President's proposal on capital gains this year is identical to the one he submitted last year. To spur long-term growth, the proposal would allow taxpayers to exclude from their income a portion of profits from the sales of assets, such as real property, ranging from 10 percent to 30 percent, depending on how long the assets are held. The President proposed a 30-percent capital gains exclusion for assets, excluding collectibles, held more than three years; a 20-percent exclusion for assets held more than two years; and a 10-percent exclusion for assets held more than one year. These exclusions would be fully phased in by 1993. As a result of the exclusion under this proposal, beginning 1993, the top tax rates on capital gains would be reduced from the current top rate of 28 percent depending on holding periods, as shown below:

Term	Exclusion	Effective Top Tax Rate
3 years	30%	19.6%
2 years	20	22.4
1 year	10	25.2

Low-Income Housing Credit

The President proposed a one-year extension for the expiring low-income housing tax credit (section 42) enacted in 1986. This provision has gained numerous supporters from Capitol Hill. In January, Senate Majority Leader George J. Mitchell, D-Maine, with 61 cosponsors, introduced a bill (S. 308) that would extend the low-income housing credit permanently as opposed to the one-year extension proposed by the President. Among the cosponsors were 12 members of the Senate Finance Committee.

The majority leader noted that, given the tight budgetary constraints, it will be difficult to extend any of the expiring tax credits. He believes that the low-income housing credit, however, deserves to be made permanent because incentives for low-income housing have traditionally been a part of the tax system. Moreover, the tax credit has helped produce almost 300,000 housing units for low- and middle-income families and has proved to be an effective means of stimulating low-income housing development. A similar bill (H.R. 413) has been introduced by House Ways and Means member Charles B. Rangel, D-N.Y.

Mortgage Revenue Bonds and Mortgage Credit Certificates

Under the President's budget, expiring provisions of mortgage revenue bonds and mortgage credit certificates would not be extended. There is, however, some interest on the Hill to extend these expiring provisions.

On the House side, Rep. Barbara Kennelly, D-Conn., has introduced legislation (H.R. 1067) to make the mortgage revenue bond and mortgage credit certificate programs permanent. The bill was cosponsored by 21 of the 36 members of the Ways and Means Committee, marking the first time a bill to extend the credits has been introduced with a majority of Ways and Means members as cosponsors. The bill also has 37 other cosponsors. A similar bill (H.R. 1070) has been introduced by Rep. Ronald K. Nachtley, R-R.I.

On the Senate side, Finance Committee member John Chafee, R-R.I., has introduced a bill (S. 167) to extend the mortgage revenue bond credits permanently. The bill has 74 Senate cosponsors.

Health Insurance Deduction for Self-Employed

The President's budget also proposed a 1-year extension of the provision to allow a 25 percent deduction for health insurance premiums of self-employed individuals. Currently, some tax writers are seeking full health insurance deduction for those who are self-employed.

House Ways and Means Committee member Byron L. Dorgan, D-N.D., has introduced a bill (H.R. 784), along with five other committee members, that would phase in 100-percent deductibility for the health insurance costs of self-employed taxpayers over five years. The bill would extend the current 25-percent deduction through 1993, increase it to 50 percent in 1994 and then allow a full deduction in 1996. A similar bill (S. 315) has also been introduced by Senator Robert Kasten, R-Wis.

IRAs for First-Time Homebuyers

To expand homeownership opportunities for first-time homebuyers who usually have difficulty accumulating the savings necessary for a downpayment, the President has included a proposal in his budget that would waive the 10-percent excise tax for first-time homebuyers on early withdrawals from IRAs to purchase homes. According to the proposal, the withdrawal could not exceed $10,000, and the price of the home could not exceed 110 percent of the median home price.

Similar bills allowing penalty-free withdrawal from IRAs have also been introduced on the Hill. On the House side, Ways and Means Committee member Robert Matsui, D-Calif., has introduced a bill (H.R. 1114) that would allow a penalty-free withdrawal from IRAs to purchase homes for IRA holders, spouses, parents and grandparents. Committee member Richard T. Schulze, R-Pa., is among cosponsors.

On the Senate side, Finance Committee member Donald W. Riegle, Jr., D-Mich., has introduced a bill (S. 307) that would allow first-time homebuyers to withdraw up to $10,000 penalty-free from IRAs to purchase principal residences. Under his proposal, IRA holders must wait at least 12 months before withdrawing from their IRAs. Also, they would be required to purchase homes within 90 days of withdrawing the funds.

In addition, Senator Lloyd Bentsen, D-Texas, Chairman of the Senate Finance Committee and fellow committee member William V. Roth, Jr., R-Del., are promoting a more generous proposal known as the Bentsen-Roth bill to be introduced this March. Among other things, the bill would allow penalty-free withdrawals from IRAs for education and major medical expenses as well as home purchases and would restore the deductibility of IRAs for upper-income taxpayers.

Enterprise Zones

The President's budget proposes establishment of "enterprise zones" to provide tax incentives for investment in up to 50 economically distressed areas. Incentives would include elimination of the capital gains tax on investment in tangible property located in the zones for at least two years, expensing of investments in certain corporate stock issued by businesses located in the zones, and 5-percent refundable tax credits of up to $525 per employee working in a zone.

Although there was wide support in Congress and the Administration for preferential tax treatment for employers who relocate in economically distressed areas last year, Congress failed to pass a bill establishing enterprise zones. On the house side, bills similar to the President's proposal were introduced by Ways and Mean Chairman Dan Rostenkowski, D-Ill., and Rep. Charles Rangel. On the Senate side, Finance Committee member Max Baucus, D-Mont., also introduced a bill authorizing the establishment of enterprize zones.

This year, Chairman Rostenkowski has reintroduced a bill establishing up to 25 enterprise zones. The bill would provide incentives that include a 10-percent wage credit for small business employers, a liberalized rehabilitation credit, 60-month amortization of child care facilities, deferral of capital gains that individuals reinvest in a zone, and ordinary loss treatment for losses on the stock or debt of corporations whose activities are concentrated in a zone.

HOME and HOPE

The new housing programs getting the most attention in the budget are Homeownership and Opportunity for People Everywhere (HOPE) and HOME Investment Partnerships (HOME), created by the National Affordable Housing Act passed last fall.

HOPE is the administration-backed initiative to help public housing residents and other low-income people buy homes. HUD estimates that 25,000 families or individuals will be able to purchase apartments or houses in the next two years.[5] Other families will be able to purchase single-family homes and units in apartment buildings that were acquired by the government after owners defaulted on HUD-insured mortgages. The Administration requested $855 million for HOPE in 1992.

HOME, initiated by Congress, will give local governments money to buy, build or rehabilitate rental housing for the poor. Local officials must provide matching funds of 25 to 50 percent of the federal grants, depending on how the money is used. Under the President's budget proposals, this program would receive $1 billion in 1992, much less than the amount envisioned in the Housing Act.

Conclusions

The projected deficit for fiscal 1992 revealed by the President's 1992 budget proposals showed little improvement over the record level of estimated deficit for fiscal 1991. The new budget process under OBRA has changed the way that discretionary spending, entitlement spending, and tax legislation are proposed in the budget. The new rules establish annual limits for discretionary spending and require that legislated changes in entitlement spending and revenues may not increase the deficit. The deficit outlook may be much worse than projected if the economy does not rebound as quickly as projected and if many savings and loan institutions continue to be insolvent.

The budget acknowledged that the nation is in recession but predicted a quick recovery by the end of the year. Most of the proposals are leftovers from previous years and there are no specific proposals to combat the recession. Simply put by Treasury Secretary Nicholas Brady, "The underlying theme [of the budget proposals], except for reintroduction of capital gains, is to leave the tax system as it is." However, many on the Hill see the capital gains proposal as an invitation for other kinds of tax changes and a trigger for the debate on the fairness issue once again.[6]

by

Orawin T. Velz, Ph.D.
Tax Economist
Forecasting and Policy Analysis Division

Endnotes

[1] The budget accounted for the costs of Operation Desert Shield, excluding expected contributions from allies, for $8 billion for the current fiscal year 1991 and $5 billion for the next fiscal year. The costs of Operation Desert Storm are scheduled to be addressed at a March 14 hearing of the Ways and Means Committee.

[2] As a percentage of gross national product, projected fiscal 1991 deficit is the second largest post-war deficit, 5.7 percent, compared to 6.3 percent in 1983.

[3] *Daily Treasury Statement*, Department of the Treasury.

[4] Debt held by the public means gross federal debt minus debt held by federal government accounts, such as debt owned by Social Security trust fund. The debt amount subject to the limit under OBRA 1990 equals gross debt minus discount adjustment from the unamortized portion of zero-coupon Treasury bonds.

[5] See Ann Mariano, "Kemp Plans Funding for Pet Programs," the *Washington Post*, February 15, 1991, p. A19.

[6] See Jackie Calmes, "Bush Proposal Revives Plan on Capital Gains," the *Washington Post*, February 5, 1991, p. A16.

References

Budget of the United States Government: Fiscal Year 1992, U.S. Government Printing Office, Washington, D.C., 1991.

Budget of the United States Government: Fiscal Year 1991, U.S. Government Printing Office, Washington, D.C., 1990.

CHECKING THE NATION'S VITAL SIGNS - NAR HOUSING AFFORDABILITY INDICES

Home ownership is vital to the financial well-being of many households. Equity in the housing asset accounts for just over one-half of the wealth of typical first-time home owners. The contribution of home equity to the wealth of nonfirst-time home owners, older home owners, and high income home owners, is smaller. Nevertheless, it is a major source of wealth even for these households.

Many analysts suggest *social* benefits -- which transcend the individual household -- accrue to the housing asset, unlike other savings instruments. For example, a 1988 NAR study finds that home owners are typically more involved in political and community activities.[1] Another study finds home owners typically maintain their residences in better condition than similar renters.[2]

Home ownership's importance for the economic well-being of households and its social benefits demand an accurate assessment of its affordability. But how do we measure housing affordability?

This is the first in a series of articles which surveys the indices and measures used to diagnose affordability problems for prospective home buyers, renters, and home owners. This article will look at four NATIONAL ASSOCIATION OF REALTORS®' (NAR) affordability indices (AIs) to *prospective home buyers*.

The first section of this article examines the mechanics of the NATIONAL ASSOCIATION OF REALTORS®' Composite, Fixed Rate Mortgage, and Adjustable Rate Mortgage AIs, and the relationship among the three AIs. The second and third sections investigate the responsiveness of the AIs to changing house prices, mortgage rates, incomes, financing and underwriting assumptions. NAR's First-Time Home Buyer Affordability Index and the adjustments it makes for the unique characteristics of first-time buyers, the homes they purchase, and the financing they obtain, is the subject of the fourth section. The limitations of all four of the indices -- Composite, Fixed-Rate, Adjustable-Rate, and First-Time Home Buyer Composite -- are addressed in the fifth section. The last section summarizes the article and previews the affordability measures to be addressed in the next article in the series.

NATIONAL ASSOCIATION OF REALTORS® Composite, Adjustable Rate, and Fixed Rate Affordability Indices

The NATIONAL ASSOCIATION OF REALTORS® Affordability Indices (AIs) track the relationship between incomes and house prices. Namely, the NAR AIs measure the potential home buyer's ability to meet the debt-service requirements of the mortgage.

NAR first calculates the income needed by a prospective home buyer to qualify for a mortgage loan on a median-priced, existing home by using a 25 percent qualifying ratio. In other words, a potential borrower is qualified for a loan if the *principal* and *interest* payment does not exceed 25 percent of borrower pre-tax income. The secondary mortgage market, on the other hand, established a 28 percent maximum principal, interest, *taxes* and *insurance* (PITI)-to-income qualifying ratio. Because the *American Housing Survey for the United States: 1987* indicates home owners spent two percent of their incomes for property taxes and nearly one percent for hazard insurance, NAR subtracts out three percent to arrive at 25 percent. NAR further assumes that a lender will lend if the principal and interest payment does not exceed one-quarter of borrower income.[3] The AI compares median family income to the income needed to qualify for the mortgage.

$$\text{NAR AI} = \frac{\text{Median Family Income}}{\text{Qualifying Income}} \times 100$$

The AI is 100 when median family income equals qualifying income; exceeds 100 when median family income is greater than qualifying income; falls below 100 when median family income is less than qualifying income. An AI value of 100 or more means that the median-income family is financially qualified, based on the simplest lender ratio, to obtain a mortgage on the median-priced home.

NAR calculates three indices corresponding to three financing assumptions. The Fixed Rate Mortgage (FRM) AI is based on interest rates on fixed rate mortgages; the Adjustable Rate Mortgage (ARM) AI on interest rates on adjustable rate mortgages; and the Composite AI on the average interest rate on fixed and adjustable rate mortgages (weighted average based on the relative shares of FRMs and ARMs closed on existing homes). All three carry a term of 30 years and a 20 percent equity downpayment, and all three AIs are calculated for the United States as a whole. (See Exhibit 1 at end of article for data sources, geographic coverage, years available and other information relevant to the Affordability Indices discussed here).

NAR also calculates the Composite, FRM and ARM AIs by region. The regional housing affordability indices reveal a striking difference in housing affordability among the Northeast, South, Midwest, and West. The AIs associated with the South and Midwest are typically higher than those of the Northeast and West.

Finally, NAR derives the Composite AI for 22 select metropolitan areas. The Composite AIs for metropolitan areas differ somewhat in that they compare the median *household* income in the area to the income needed to qualify for the mortgage. (See Exhibit 1 at end of article).

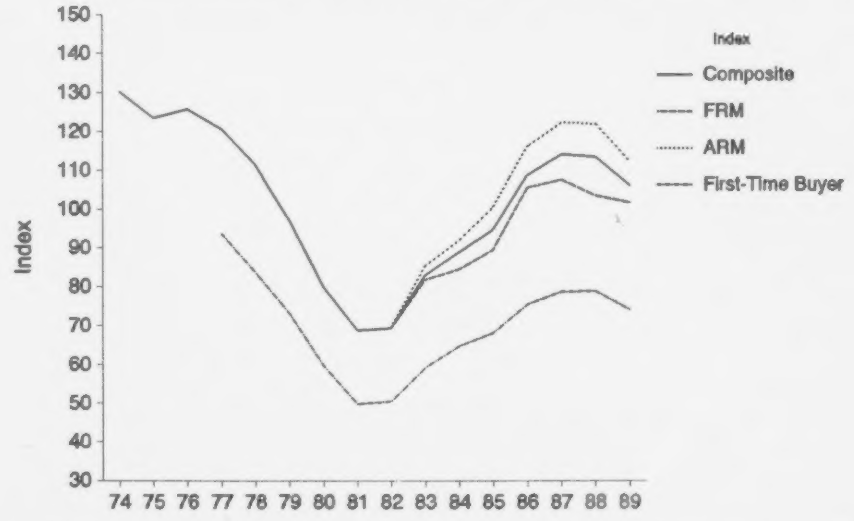
While the AIs change over time, the relationship between the three indices is constant: the FRM AI is the lowest, the ARM AI is the highest. This constant relationship derives from a lender's ability to adjust the rate on an ARM at set intervals, thereby reducing the risk associated with "lending long." The lender can offer a lower initial mortgage rate and, thus, a lower principal and interest payment. (It is important to note the ARM AI does not take into account subsequent adjustments to the mortgage rate). The lower monthly payment lowers the income needed to qualify, and the lower qualifying income raises the ARM AI above the FRM AI. (See Graph 1 for trends in and relationship among the three indices. The First-Time Home Buyer Index, to be discussed later, also appears on the Graph 1).

How Sensitive Are the AIs?

How sensitive are the affordability indices to changes in home prices? mortgage rates? family incomes? To answer these questions, we will look at the impact on the NAR Composite AI for the United States of a one percent change from the 1990 baseline in each of these components. The effects on the Composite AI of a one percent increase in median house price from $95,500 to $96,455; a mortgage rate increase from 10.04 percent to 10.14 percent; a median income increase from $35,581 to $35,937, are a decrease of 1.1, a decrease of 0.9, and an increase of 1.1 percent, respectively. (A one percent *decline* from the 1990 baseline in each of the components has the same effect only *in the opposite direction*). But, what happens if house prices and incomes both increase by one percent above the 1990 baseline; in other words, the median house price increases from $95,500 to $96,455 *and* the median family income increases from $35,581 to $35,937? The negative

Graph 1

NAR HOUSING AFFORDABILITY INDICES



SOURCE: Home Sales Yearbook: 1989, NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division, 1990 impact on the Composite AI of the one percent increase in the home price is nullified by the positive impact of the one percent increase in family income. The Composite Affordability Index, therefore, is unaffected by equal changes in home prices and incomes. Since in the long-run, home prices and incomes generally move together, the mortgage rate appears to be the "driving force." (This will be discussed in some detail in the next section).

Are the impacts on the Composite Affordability Index of changes in home prices, mortgage rates, and family incomes the same for different assumptions about the baseline? The answer is, while the *direction* of the change in the AI would be the same, the *magnitude* of the change would differ. Take the high-priced Boston market where the median home price for third quarter 1990 (baseline price) is $175,900. A one percent increase above the baseline would raise the median price to $177,659. The qualifying income would then increase from $60,678 to $61,285. (Median household income is unaffected by the rise in home price, and is $36,914 in Boston during the third quarter of 1990). The Composite Affordability Index for Boston, therefore, would fall from 60.8 to 60.2 -- a decline of 0.6. Similarly, a one percent increase in the mortgage rate above the Boston third-quarter 1990 baseline would decrease the Composite AI by 0.5; a one percent rise in median household income above the baseline would increase the Composite AI by 0.6. Finally, simultaneous increases of one percent in home price and household income leave the NAR Composite Affordability Index for Boston unchanged.

Table 1 shows how the Composite AI for the United States responds to *typical* changes in the components and underlying assumptions of the NAR Composite AI. A four percent increase in home prices (Line 2), typical of those experienced during the late 1980s, raises the mortgage principal and interest payment and the qualifying income above the 1990 baseline. Thus the ratio between median family and qualifying income, that is the Affordability Index, decreases by 4.2 points.

An increase in the mortgage rate (Line 3) also reduces the Composite AI. A five percent increase in the mortgage rate, that is, a one-half of one percentage point rise (other assumptions remain the same as in 1990) increases the monthly principal

TABLE 1

SENSITIVITY OF NAR COMPOSITE AFFORDABILITY INDEX TO CHANGING ASSUMPTIONS

	Home Price	Mortgage Rate	Principal and Interest	Property Tax and Insurance	Monthly Mortgage Payment	Payment as % of Family Income	Median Family Income	Qualifying Income	Composite Affordability Index	Difference From Baseline Index
1990 baseline*	$95,500	10.04%	$673	-	$673	22.7%	$35,581	$32,286	110.2	-
Typical variations in **baseline assumptions:**										
4% rise in home price	99,320	10.04	699	-	699	23.6	35,581	33,552	106.0	(4.2)
5% rise in mortgage rate	95,500	10.54	701	-	701	23.6	35,581	33,655	105.7	(4.5)
5% rise in family incomes	95,500	10.04	673	-	673	21.6	37,360	32,286	115.7	5.5
10% down payment	95,500	10.29**	773	-	773	26.1	35,581	37,092	95.9	(14.3)
28% maximum PITI-to-income	95,500	10.04	673	89	762	25.7	35,581	32,655	109	(1.2)

* Existing and New, Single-Family Apartment Condos and Co-ops, NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division, January 1991.

** Includes 0.25 percentage points for private mortgage insurance.

and interest payment, the qualifying income, and ultimately reduces the Composite AI by 4.5 points.

Family income changes (Line 4) also affect the Index. Unlike home prices and mortgage rates, however, changes in family income do not affect qualifying income. Rather, a change in family income alters the ratio of family income to the income needed to qualify. A five percent increase in median family income (an increase typical of the mid- to late-1980s) raises the AI 5.5 points above the 1990 baseline.

Line 5 highlights the "trade-off" a borrower makes when he obtains a mortgage with a lower equity downpayment. The lower 10 percent downpayment boosts the monthly mortgage payment above the baseline in two ways. First, the amount of principal the borrower must repay increases. Second, the lender requires the borrower to obtain private mortgage insurance until the borrower's equity stake in the home reaches 20 percent through principal repayment and price appreciation. (NAR adds 0.25 percentage points to the mortgage rate to account for the private mortgage insurance required). The increased principal amount and the mortgage insurance required raise the monthly payment by $100, roughly *15 percent.* The income needed to qualify increases from $32,286 to $37,092, well above the median family income of $35,581. The AI falls to 95.9 -- nearly *15 percent* below the 110.2 associated with the 1990 baseline.

Changing to a 28 percent maximum PITI-to-income convention (Line 6) has little effect on the Composite AI. As previously stated, home owners spent roughly three percent of their incomes for property taxes and insurance combined. An appropriate estimate of monthly property taxes and insurance payments for this example, then, is (3%) x ($35,581 median family income) / (12 months) or $89. The total monthly mortgage payment goes up by this $89. The income needed to qualify increases by only *one percent*, and the AI decreases by just over *one percent.*

Are the AIs Hypersensitive to Mortgage Conditions?

A look at NAR AIs over the past two decades establishes the interest rate as the "driver" of the AI. This is not surprising given that NAR began calculating the AI in 1982 *specifically* to examine how high interest rates hurt the housing market. R. Kamath in "The Measurement of Housing Affordability" (1988) finds that changing mortgage rates accounted for much of the movement in the NAR Composite AI for the United States during 1972, 1979, 1981, and 1982.[4] Since home prices and incomes generally move in tandem, large swings in the mortgage rate make the AI volatile.

Data on home prices, income, and interest rate dynamics since 1982 highlight this sensitivity. Table 2 shows that the favorable interest rate climate until 1988 (decreases in each year until 1988) yielded increases in the Composite AI each year, despite *rising home prices.* The slight rise in interest rates in 1988 caused a slight drop in the Composite AI. But in 1989, the nearly nine percent rise (rise of nearly one percentage point) in the mortgage rate caused the AI to drop from 113.5 to 108.1.

Getting to the Root of the Problem: NAR First-Time Home Buyer Affordability Index

The NATIONAL ASSOCIATION OF REALTORS® also calculates a First-Time Home Buyer AI to recognize the special characteristics of first-time home buyers and the homes they purchase. (See Exhibit 1 at end of article for data sources, geographic coverage, years available and assumptions. Refer to Graph 1 for historical trend in First-Time Home Buyer Index). Home sales data from NAR's *Home Buying and Selling Process: 1987*, reinforced by data from NAR's report, *Home Financing Transaction: 1987*, suggest the median sales price of homes purchased by first-time home buyers is only 85 percent of the median price of homes purchased by all home buyers combined. The First-Time Home Buyer AI, therefore, uses this lower price.

Aside from property characteristics, the financial characteristics of prospective first-time home buyers differ from the overall home buying population. NAR finds that income for young (ages 25 to 44) renting families, the group most likely to purchase a first home, is about 30 percent lower than the median income for all families. The First-Time Home Buyer AI considers this lower income in its calculation. Also, prospective first-time home buyers generally have less savings because they are younger. This lower savings coupled with their absence of home equity means first-time buyers typically make downpayments of seven to ten percent. The First-Time Home Buyer AI considers these factors and uses a 10 percent downpayment, adding one-quarter of one percentage point to the mortgage rate for the required private mortgage insurance. (It is important to note that prospective buyers with less than a 10 percent downpayment are entirely lost to the index).

TABLE 2

HOME OWNERSHIP AFFORDABILITY

	Median-Priced Existing Single-Family Home	Percent Change	Mortgage Rate*	Percent Change	Median Family Income**	Percent Change	Composite Affordability Index
1984	$72,400	-	12.49%	-	$26,433	-	89.1
1985	75,500	4.3%	11.74	-6.0%	27,735	4.9%	94.8
1986	80,300	6.4	10.25	-12.7	29,458	6.2	108.9
1987	85,600	6.6	9.28	-9.5	30,970	5.1	114.2
1988	89,300	4.3	9.31	0.3	32,191	3.9	113.5
1989	93.100	4.3	10.11	8.6	34,213	6.3	108.1

*Effective rate on loans closed on existing homes -- Federal Home Loan Bank Board
**U.S. Bureau of the Census data.

SOURCE: *Home Sales: Existing and New Single-Family, Apartment Condos and Co-ops*, NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division, December 1990, p. 12.

NAR AIs: "Good Tools for Monitoring Improving or Worsening Affordability Conditions"

The most common criticism of the NAR AIs lies in their assumptions about downpayments of prospective first-time home buyers. NAR introduced its First-Time Home Buyer Index in 1988, with its lower 10 percent downpayment to address this criticism as well as the other special characteristics of the first-time buyer. But even this 10 percent downpayment is a troubling assumption for many prospective first-time home buyers. The Joint Center for Housing Studies of Harvard University's *State of the Nation's Housing: 1990* reports that 71 percent of renters between the ages of 25 and 34 have insufficient wealth to make a 10 percent equity downpayment and pay closing costs associated with the home sale. Closing costs are formidable; unpublished NAR tabulations suggest the buyer portion alone can be as high as five to seven percent of the home sales price in some areas.

Another impediment to housing affordability which the NAR AIs do not address is the high cost of *operating* the home once it has been purchased. The home owner must not only pay the mortgage principal and interest, property taxes and hazard insurance, but also must pay other operating costs, including utilities, maintenance and repairs. These costs can be substantial; there is general consensus that annual maintenance and repair costs are on the order of one to three percent of house value.

Other criticisms of the NAR AIs relate to less significant issues than the household's ability to make the downpayment and to operate the home once it has been purchased.[5] Affordability is based on the median-income family finding financing similar to that assumed in the NAR AIs. The NAR AIs also assume that the median-income family would wish to purchase the median-priced home *and* would be willing to spend the maximum percentage of its income for mortgage payments allowed under underwriting guidelines to do so. The monthly mortgage payments of the indices do not include property taxes and insurance, and NAR adjusts the maximum monthly mortgage payment-to-income ratio accordingly. This is troublesome in high property tax localities, where home owners may spend more than the two percent of their incomes for property taxes assumed in the NAR AIs. The NAR AIs (except for the composite, metropolitan area indices) use family income instead of household income, despite increasing home ownership rates among nontraditional household types. The AIs ignore the level of household debt, despite important restrictions imposed by the secondary market on the amount of debt.

The limitations of the NAR AIs do not undermine their worth as good tools for monitoring whether affordability conditions are improving or worsening in an area. (Refer to Graph 1 for trends in national housing affordability). The NAR Composite AI, in fact, is viewed as a good measure for repeat home buyers, who can "rollover" their equity in their current homes into equity downpayments on the purchase of repeat homes.

Conclusion

Home equity is an important source of wealth for first-time home owners, and to a lesser extent, nonfirst-time home owners, older home owners, and high income home owners. The declining affordability of home ownership, therefore, constitutes a serious threat to the financial health of many of the nation's households by preventing households from accumulating wealth through home equity. The measurement of an affordability problem is essential to its proper treatment. But what instrument is best used for the diagnosis?

The NAR AIs measure housing affordability to prospective home buyers. In particular, they measure the ability of a family with the median income to qualify for a mortgage loan on the existing, median-priced house. The NATIONAL ASSOCIATION OF REALTORS® also calculates first-time home buyer indices which consider the special characteristics of this home buying population.

While the NAR AIs gauge the ability of families to meet the debt-service requirement of the home mortgage based on one lender ratio, they do not address two other important dimensions of home ownership affordability: the family's ability to meet the downpayment and closing costs and the family's ability to "operate" the house once it is purchased. Research, which has already commenced, should continue to be directed toward the measurement of the downpayment/closing cost and operating cost constraints of home ownership.

The next article in the series will begin with a brief discussion of state associations which have calibrated the NAR Affordability Indices to their own housing markets. It will then proceed with an investigation of *market* measures of home ownership affordability. These include the "share of homes" on which the median-income prospective home buyer family can qualify for financing approach and the "share of households" which can qualify for financing on a criterion home approach. The article will then look at the "30-percent of income for housing" affordability measure -- the standard for federal housing subsidy programs, and the Joint Center for Housing Studies of Harvard University's cost burdens. The 30-percent of income standard and cost burdens are particularly relevant for renters and households which already own their homes.

by
Mary Boehling Schwartz
Housing Economist
Forecasting and Policy Analysis Division

1. *Real Estate in the Economy: Impacts on GNP, Income and Employment*, NATIONAL ASSOCIATION OF REALTORS®, staff study, November 1988.

2. George C. Galster, "Empirical Evidence on Cross-Tenure Differences in Home Maintenance and Conditions," Land Economics, Vol. 59, (1983).

3. Glenn E. Crellin, *Measuring Housing Affordability: Current Approaches and Future Directions*, paper presented to American Real Estate Society, March 30, 1990. He explains the NATIONAL ASSOCIATION OF REALTORS® rationale for omitting the property tax and insurance components. In particular, he notes that property taxes on "similarly-valued" homes differ markedly among different localities.

4. Ravindra Kamath, "The Measurement of Housing Affordability," Real Estate Issues, Volume 13, No. 2, Fall/Winter 1988.

5. Almon R. Smith, *Housing Affordability Indexes As Predictors of Sales of Existing, Single-Family Homes in the United States*, unpublished dissertation, Nova University, 1988 addresses many of the criticisms of the NAR Composite AI and makes appropriate modifications to his own measure.

EXHIBIT 1

Index (Coverage)	Objective	Home Price	Mortgage Rate *	Mortgage Term	Down Payment	Income	Ratio of Mortgage Payment ** to Income	Years Available
NAR Fixed Rate Mortgage Affordability Index (U.S., four Census Regions)	Can family with median income qualify for financing on median-priced home?	Median-priced, existing, single-family home; from over 475 Boards of Realtors® and Multiple Listing Services	Current, effective mortgage rate on FRMs on loans closed on existing homes; from the Federal Home Loan Bank Board	30 years	20% (80% LTV)	Median family income; from U.S. Bureau of the Census, Series P-60	Cannot exceed 25%	U.S. Index Annually 1970 forward; monthly 1981 forward; Regional monthly July 1989 forward
NAR Adjustable Rate Mortgage Affordability Index (Same as above)	Same as above	Same as above	Current, effective mortgage rate on ARMs on loans closed on existing homes; from the Federal Home Loan Bank Board	Same as above	Same as above	Same as above	Same as above	Same as above
NAR Composite Affordability Index (Same as above plus Select MSAs)	Same as above (except for metropolitan areas - median income household used)	Same as above	Average interest rate on FRMs and ARMs on loans closed on existing homes; current, effective rate; from the Federal Home Loan Bank Board	Same as above	Same as above	Same as above (except for metropolitan areas - household income from CACI) ***	Same as above	U.S. Index Annually 1970 forward; monthly 1971 forward; Regional monthly July 1989 forward; MSA annually 1987 forward; quarterly April 1989 forward
NAR First-Time Home Buyer Composite Affordability Index (U.S.)	Can first-time home buyer family with median income qualify for financing on median-priced starter home?	85% of above	Above rate plus 0.25% for private mortgage insurance (pmi)	Same as above	10% (90% LTV)	Roughly 70% of above	Same as above	Annually 1977 forward; quarterly 1981 forward

* Effective rate includes amortized fees and loan points.

** Mortgage principal and interest payment is calculated from home price, mortgage rate, term and loan-to-value (LTV). The NATIONAL ASSOCIATION OF REALTORS® does not include property taxes and hazard insurance in the mortgage payment.

*** CACI is an international professional and high-technology services organization whose services include the provision of demographic information for U.S. households.

U.S. Economic Outlook: March 1991

Quarterly figures are seasonally adjusted annual rates

	90.3	90.4	91.1	91.2	91.3	91.4	92.1	92.2	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	1.4	-2.0	-2.4	0.2	3.1	3.3	3.2	2.9	2.5	0.9	-0.1	2.9	2.6
Industrial Production	4.0	-7.5	-7.5	-2.3	3.6	3.8	1.9	3.9	2.6	1.0	-2.4	3.5	4.7
Civilian Employment	-1.3	-0.9	-1.9	-0.6	0.3	0.9	1.3	1.5	2.0	0.5	-0.8	1.1	1.4
GNP Inflation Index	3.7	2.8	4.3	3.3	3.1	2.8	3.2	2.6	4.1	4.1	3.5	2.9	2.7
Consumer Prices	6.9	7.0	3.6	2.3	3.7	3.5	3.5	3.3	4.8	5.4	4.4	3.4	3.1
Value of the U.S. Dollar	-20.7	-19.0	-0.2	3.4	1.1	3.7	4.0	3.8	6.2	-9.6	-6.0	3.5	3.1
Percent													
Mfg. Capacity Utilization	82.9	80.7	78.6	77.9	78.4	78.9	79.0	79.4	83.9	82.3	78.4	80.2	82.9
Civilian Unemployment	5.6	5.9	6.5	6.7	6.7	6.6	6.5	6.3	5.3	5.5	6.6	6.2	5.7
Percent of GNP													
Federal Tax Receipts	20.4	20.6	20.5	20.5	20.6	20.7	20.8	20.8	20.2	20.3	20.6	20.8	20.7
Federal Expenditures	23.1	23.7	23.9	24.2	24.0	24.0	24.1	23.7	22.8	23.4	24.0	23.7	23.4
Federal Budget Deficit	-2.6	-3.2	-3.4	-3.7	-3.4	-3.3	-3.2	-2.9	-2.6	-3.0	-3.4	-2.9	-2.7
Interest Rates, Percent													
Federal Funds Rate	8.2	7.7	6.4	6.5	7.0	7.3	7.4	7.3	9.2	8.1	6.8	7.3	7.2
3-Month T-Bill Rate	7.5	7.0	6.0	5.8	6.0	6.2	6.3	6.2	8.1	7.5	6.0	6.3	6.1
Prime Rate	10.0	10.0	9.2	9.2	9.4	9.6	9.0	8.8	10.9	10.0	9.4	8.9	8.8
Discount Rate	7.0	6.9	6.2	6.1	6.3	6.5	6.5	6.5	6.9	7.0	6.2	6.5	6.4
Corporate AAA Bond Yield	9.4	9.3	8.8	8.6	8.4	8.3	8.2	8.1	9.3	9.3	8.5	8.1	8.1
30-Year Government Bond Yield	8.8	8.5	8.1	7.8	7.7	7.7	7.6	7.6	8.4	8.6	7.8	7.6	7.7
Mortgage Rates, Percent													
30-Year Fixed Rate	10.1	10.0	9.3	9.1	8.9	8.9	8.8	8.7	10.3	10.1	9.1	8.8	8.8
1-Year Adjustable	8.4	8.1	7.6	7.4	7.4	7.4	7.4	7.5	9.3	8.4	7.5	7.5	7.5
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	4,127	3,879	3,662	3,864	4,163	4,287	4,403	4,491	4,442	4,179	3,994	4,505	4,624
Existing Single-Family Sales	3,297	3,117	2,973	3,081	3,287	3,397	3,469	3,544	3,467	3,305	3,185	3,551	3,666
New Single-Family Sales	523	472	439	462	509	546	568	581	654	533	489	586	620
Housing Starts	1,131	1,044	927	1,010	1,141	1,157	1,225	1,262	1,381	1,203	1,059	1,273	1,307
Single-Family Units	856	786	710	808	903	918	963	976	1,005	901	835	983	987
Multi-Family Units	274	258	218	202	237	239	263	285	376	302	224	290	320
2-4 Family Units	32	31	26	24	29	29	32	34	56	37	27	35	38
5+ Family Units	242	227	191	178	209	210	231	251	320	265	197	255	282
Mobile Homes Shipped	188	178	185	212	230	237	242	245	199	188	216	246	243
Percent change -- Year Ago													
Total Single-Family Sales	-6.5	-13.8	-18.2	-8.7	0.9	10.5	20.2	16.2	-4.4	-5.9	-4.4	12.8	2.6
Existing Single-Family Sales	-4.3	-11.9	-13.6	-8.4	-0.3	9.0	16.7	15.0	-3.6	-4.7	-3.6	11.5	3.2
New Single-Family Sales	-25.2	-27.6	-26.6	-14.3	-2.7	15.7	29.5	25.9	-3.3	-18.5	-8.3	19.8	5.9
Housing Starts	-16.1	-22.8	-35.3	-16.1	0.9	10.9	32.1	24.9	-7.2	-12.9	-12.0	20.2	2.7
Single-Family Units	-14.6	-21.0	-33.3	-9.8	5.5	16.9	35.6	20.8	-7.2	-10.4	-7.3	17.8	0.4
Multi-Family Units	-20.6	-27.9	-41.0	-34.4	-13.4	-7.4	20.8	41.3	-7.2	-19.6	-25.9	29.3	10.6
2-4 Family Units	-43.2	-42.2	-39.2	-44.0	-10.8	-7.4	20.8	41.3	-5.1	-32.8	-27.9	29.3	10.6
5+ Family Units	-16.2	-25.3	-41.3	-32.9	-13.8	-7.4	20.8	41.3	-7.6	-17.3	-25.6	29.3	10.6
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.6	92.2	93.6	94.4	95.7	98.7	100.9	101.9	92.9	95.2	95.6	102.5	107.3
New Home Prices	116.7	121.9	122.5	123.2	124.6	126.9	128.7	130.5	120.4	122.1	124.3	131.3	137.8
Percent Change - Year Ago													
Existing Home Prices	1.8	-0.5	-2.4	-1.9	-0.9	7.0	7.8	7.9	4.2	2.5	0.4	7.2	4.6
New Home Prices	-2.5	-2.0	-0.6	-2.7	6.8	4.1	5.1	6.0	6.2	1.4	1.8	5.6	5.0

Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

A 7000-1

REAL ESTATE OUTLOOK

Vol. 4, No. 4

April 1991

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- March's employment figures -- including a jump in the unemployment rate to 6.8 percent -- dispel the notion that February's cease fire in the Persian Gulf would immediately lift the economy out of the downturn. The roots of the recession are deeper than the fall's flare-up of oil prices and plunge in consumer confidence. Nevertheless, the recovery is still expected to be in place by mid-summer. Consequently, the two halves of 1991 will appear in sharp contrast to each other. The first half will see the economy contract at a 1.2 percent annual rate, while the second half is expected to expand at a healthy 3.0 percent annual rate.

- Underlying economic fundamentals suggest that the recession is nearing the end of its run. The Federal Reserve is using monetary policy to promote recovery through lower interest rates. Fiscal policy has also added some short-term stimulus through increased defense spending.

- Good news is also appearing in other, less discretionary, areas. Oil prices seem to have settled down close to $20 per barrel, returning to their pre-invasion levels after flirting with a $40 price last October. The Dow Jones Industrial Average has advanced over 17 percent since the war began, a good sign since a stock market rally during a recession is a reliable predictor of an oncoming recovery.

- Meanwhile, housing starts and home sales both turned up impressively in February after dismal January performances. Led by single-family starts, total housing starts posted a 16.4 percent increase in February, reaching an annual rate of 989,000 units. This increase is the biggest monthly gain in over a year and more than reverses January's steep decline.

- In the market for new homes, sales were 16.2 percent higher than January's level of 402,000 units. Sales of existing homes recorded their largest gain since April of 1986, increasing 7.9 percent to 3.13 million units.

IN THIS ISSUE

NATIONAL ASSOCIATION OF REALTORS®
REALTOR® *The Voice for Real Estate*™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991 NATIONAL ASSOCIATION OF REALTORS®

Choices

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

Did you ever have to make up your mind?
Pick up on one and leave the other behind?
It's not often easy, it's not often kind.
Did you ever have to make up your mind?

One of the most frightening aspects of large cities is the myriad of choices they present. Where to walk? What to see? Which choice of food? These are compounded in the capitalist world where the market has expanded those choices geometrically. In a sense, life is never as tough as when it presents the most choices. And believe or not, in this second year of the last decade of the Twentieth Century, the American economy is getting real tough.

It doesn't seem that way, though. In the glow of postwar euphoria, Americans have seemingly returned to the habits that built the great expansion of the Eighties. Consumers have come out of their long hibernation of doubt, returned to the mall, and appear to be making up for lost time. And when all the troops finally come home, consumption will get yet another boost.

This seems great, and in a way it is. The current microburst of home sales and construction activity will help end the recession and start the economy back on a growth track. Increased consumption spending will help restore the employment losses that were the immediate cause of the slump. We fully expect that the first quarter of 1991 will be the last for any significant GNP declines for quite a while. The second quarter will be no great shakes (and may even show a slight contraction) but will clearly mark the end of the downturn, and healthy growth will return in the second half of the year.

But that's not the whole story; it may not even be the most important chapter. The resumption of our merry consumption ride will produce short-term growth, jobs and a happier America. But if we allow the nearsightedness that afflicted the Eighties to infect the Nineties, then expansion will be the exception and stagnation the norm.

The catalogue of our woes is long: a federal deficit that not even the riches of Croesus can quench; an aging infrastructure and outmoded capital; an educational system that continues to produce mediocrity; and on and on. None of these problems will reach up and bite us in the near term. If we focus on the joys of victory and resume our spending spree, we can even sweep these under the rug for now.

Eventually, though, these are our challenges. We are facing a real choice. We are rich enough to live well; we are powerful enough to remain a world factor. But over the long haul, our continued well-being requires us to be ants rather than grasshoppers. The real economic need is not renewed consumption, as seductive as that might seem in this time of recession, but rather new investment.

That is much more easily said than done. We are not (thank God!) a centrally planned system where more investment and less consumption can be ordered up. The fragmentation of the Soviet Union shows what a colossal failure that approach can be. In our system, the marketplace provides incentives to move economic agents in one direction or another. The problem is that many of the incentives driving our economy are now operating in the wrong direction.

A marvelous case in point is the withdrawal of the banking system from the real estate finance business. There are many reasons for this: many markets were overbuilt through Eighties euphoria; anti-investment tax changes drained the value from real estate projects; the thrift collapse has sent a shiver through the commercial banking community; and new capital standards are forcing institutions to reorder their portfolios.

But, ultimately, this retreat is good for neither the economy nor the banks. Real estate is a powerful force in national output, accounting for nearly a fifth of all economic activity. To choke the lifeblood from this sector through the denial of credit, and force firm after firm into bankruptcy is so shortsighted as to be ludicrous. Economic correction, like all things, is good only when not overdone.

Similarly, the credit crunch is bad for banking. In the early Eighties, banks were forced out of the commercial loan market by the advent of "junk" bonds. Firms simply went directly to the capital market for funding. Now banks are abandoning the real estate sector of their own volition. What's left? Clearly, the next stop for the banks is to specialize in the financing of consumption, hardly the way to support the economy's long-term investment needs.

Can this be reversed? Perhaps. Even with the new capital regulations, banks could be attracted into longer term financing through changes in the tax system that restore value to investment. Returning to the pre-1986 treatment of capital gains, passive losses in real estate and depreciation lives would restore sufficient value to bring both investors and financing into the reconstruction of our economic infrastructure.

That's but a single example of the challenges that permeate the entire economy. We live in an integrated economy, where technology has brought the world together and is erasing boundaries of time and space. The leaders in that global economy will be the ones who think, plan and act with a long-term perspective, a view that accentuates the future and deemphasizes the present.

Achieving that view in the current economy involves a change of mindset. It's a difficult change, because the past twenty years have seen extreme swings between austerity and excess. It's hard to think of planning for the future except in terms of impoverishing the present. The reality is that the necessary shifts are marginal -- they may pinch but they will not strangle. But it's a challenge. Somewhere between the asceticism of Carter and the overindulgence of Reagan is the fertile middle ground. We need to find and cultivate it.

Outlook for the Economy and Real Estate

Just six weeks ago, it seemed unlikely, but, as of mid-April, neither the Republican Guards nor the recession has been brought to bay. Many thought that February's cease-fire would immediately lift the economy out of the downturn. A recession born of the oil shock and plummeting consumer confidence last fall would fade as quickly as Saddam's army in the onslaught of victory, lower oil prices, and consumer euphoria. But March's employment figures -- including a jump in the unemployment rate to 6.8 percent -- dispel the notion of a quick and easy end to the recession.

Others, including NAR, thought that the recession had deeper roots and would linger for a few more months, like a nagging cough after a bad cold. Although the recession seems to be a more virulent strain than had been diagnosed earlier, the recovery is still expected to be in place by mid-summer. Consequently, the two halves of 1991 will appear in sharp contrast to each other. The first half will see the economy contract at a 1.2 percent annual rate, while the second half is expected to expand at a healthy 3.0 annual rate.

The quarterly pattern of economic growth suggests that the worst of the recession is behind us. After two quarters of contraction, the economy in the April-June period is projected to grow at a slight 0.3 percent annual rate. Growth during this period appears tenuous, and a third consecutive quarter of contraction would not be a surprise. What would be surprising is to have the economy still sliding in the July-September period. Instead, solid growth is expected in the year's third quarter.

Some Signs of the Sprouting Recovery

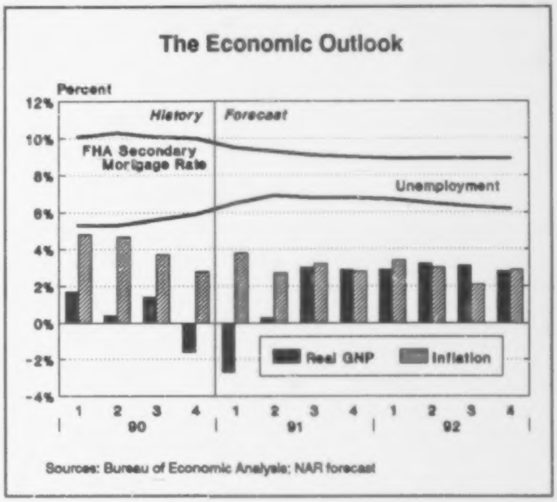
The underlying economic fundamentals suggest that the recession is nearing the end of its run. The Federal Reserve is using monetary policy to promote recovery through lower interest rates. In response, the bellweather federal funds rate has dropped more than 2 percentage points, from about 8.25 percent last summer to 6 percent for the first week of April. Fiscal p[illegible] practiced by Congress and the Administration, has added a short-term stimulus through increased defense spending, countering the contractionary effects of the higher taxes resulting from last fall's budget agreement.

Good news is appearing in other, less discretionary, areas. Oil prices seem to have settled down close to $20 per barrel, returning to their pre-invasion levels after flirting with a $40 price last October. The Dow Jones Industrial Average has advanced over 17 percent since the war began, which is a good sign since a stock market rally during a recession is a reliable predictor of an oncoming recovery. Meanwhile, home sales and housing starts both turned up impressively in February after dismal January performances. While construction expenditures and manufacturers' orders both slipped in February, the declines were significantly less than the declines recorded in January, suggesting a recession hitting bottom.

Consumers Continue to Hold Back

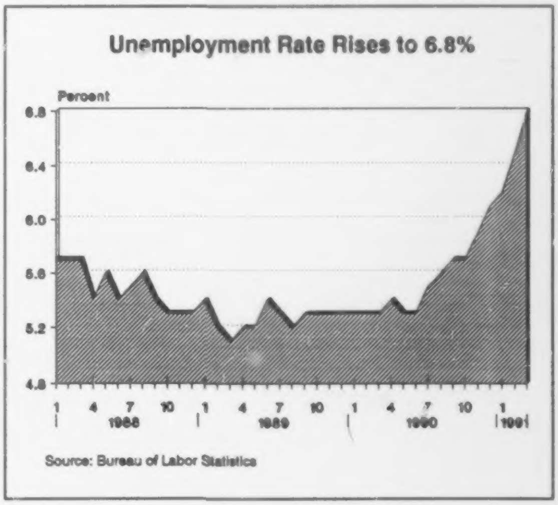
In the Eighties, the expansion seemed like the Energizer bunny -- it just kept going and going and going. But slowing income growth, stalled productivity gains, sagging job creation and stubborn inflation sapped the economy of

The Economic Outlook



Sources: Bureau of Economic Analysis; NAR forecast

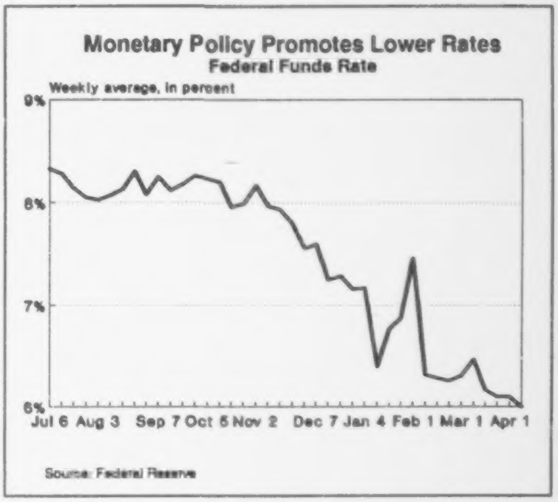
Unemployment Rate Rises to 6.8%



Source: Bureau of Labor Statistics

Monetary Policy Promotes Lower Rates

Federal Funds Rate



Source: Federal Reserve

its energy. Seemingly indefatigable consumers, who account for about two-thirds of demand in the economy, wound down their spending at the end of the decade. As illustrated by the chart to the immediate right, consumer spending was sharply lower in the 1989-90 period relative to the expansion as a whole. This retrenchment made the expansion vulnerable to last fall's oil shock.

Squeezed by prospective job losses and slow income growth, consumers aren't ready to power the recovery just yet. By saving at historically low rates, consumers didn't create much of a safety net for themselves during the last half of the Eighties. Certainly consumers are perkier now than nine months ago, but, relative to other recoveries, they are remaining very careful with their cash. Auto sales in March were poor, and there are indications that consumer demand in other areas remained sluggish. The rebound in consumer spending in the third quarter is expected to be only two-thirds of the typical gain recorded in the first full quarter of recovery.

Rebound's Vigor Reined in By Financial Stress

In addition to cautious consumers, the credit crunch is expected to inhibit the recovery in the second half of 1991. Credit demand will pick up as the economy rebounds, but the struggling banking sector will continue to be extremely careful about making loans. Since banks are an important conduit in translating the Fed's easier monetary policy into a solid recovery, their inability or unwillingness to extend credit could seriously hamper the recovery. Nowhere will this be more evident than in the real estate industry.

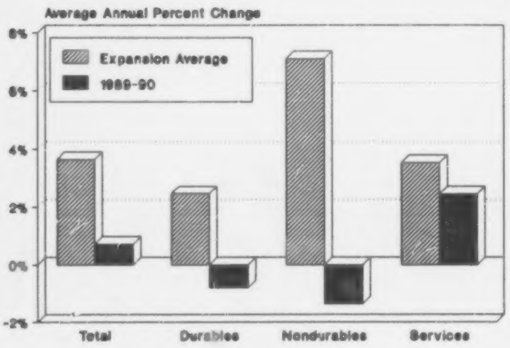
Waiting for the Monetary Tonic to Work

The labor markets continued to deteriorate in March when, for the ninth consecutive month, nonfarm payrolls shrunk. The loss of 205,000 jobs brings the total number of cutbacks to 1.6 million positions since June. Although job losses typically continue to mount even at the outset of a recovery, the high figure was disappointing.

The Fed's reaction to the release of these figures was telling: After easing immediately following the release of the two previous employment reports, the Fed stood pat. Perhaps the Fed is willing to ride out the weak numbers a bit longer and give its previous easing measures more time to work. The Fed is probably also concerned with the recent inflation numbers. The so-called core rate of inflation -- the Consumer Price Index less the volatile energy and food components -- has recorded big gains in the past two months, as shown in the chart at right. Concerned that easing now would hasten the recovery only a little while risking an outburst of inflation, the Fed may wait until mid-April to ease again, taking its cue from the inflation numbers due out at that time.

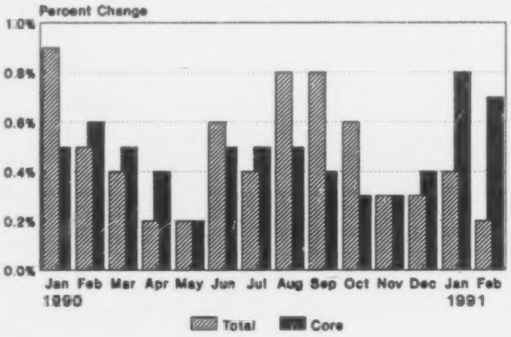
But there are other signs that inflation won't burst out: Besides lower oil prices, a steep decline was reported in a price index maintained by the National Association of Purchasing Managers, indicating continued softness in the economy. And the Commodity Research Bureau's index of futures prices on raw materials such as metals, grains, livestock and lumber has continued the decline that started last fall.

Drop In Consumption Expenditures Isn't New



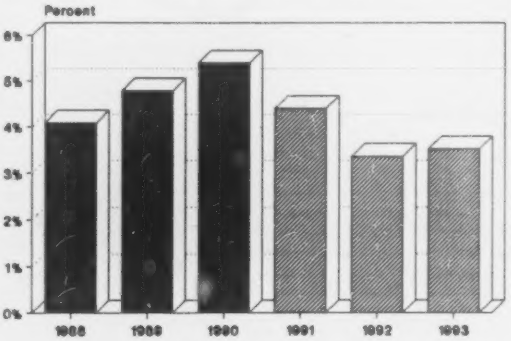
Source: Bureau of Economic Analysis

Increases In Core Inflation Cause Concern
Consumer Price Index



Source: Bureau of Labor Statistics

Milder Inflation Expected In 1991-93
Consumer Price Index



Source: Bureau of Labor Statistics; Real Estate Outlook Forecast

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

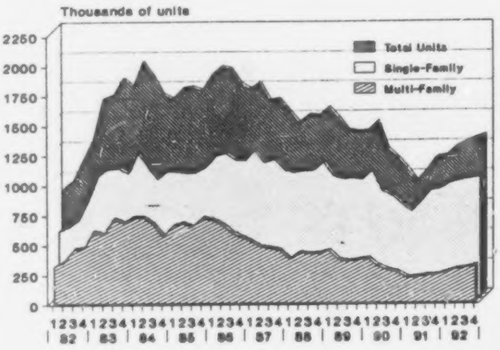
	Total	SF	2-4	5+
Feb 1990	1,459	1,127	41	291
Oct 1990	1,026	839	22	165
Nov 1990	1,130	769	54	307
Dec 1990	971	751	17	203
Jan 1991	850	652	28	170
Feb 1991	***989***	***771***	***49***	***169***
Annual Averages:				
1989	1,381	1,005	56	320
1990	1,203	901	37	265
Percent Changes in February 1991 since:				
Feb 1990	-32.2	-31.6	19.5	-41.9
Jan 1991	16.4	18.3	75.0	-0.6

Regional Data

	Northeast	Midwest	South	West
Feb 1990	221	285	572	381
Oct 1990	144	230	392	260
Nov 1990	147	232	483	268
Dec 1990	110	233	395	233
Jan 1991	87	167	356	240
Feb 1991	***92***	***296***	***384***	***217***
Annual Averages:				
1989	181	269	535	397
1990	135	259	478	330
Percent Changes in February 1991 since:				
Feb 1990	-58.4	3.9	-32.9	-43.0
Jan 1991	5.7	77.2	7.9	-9.6

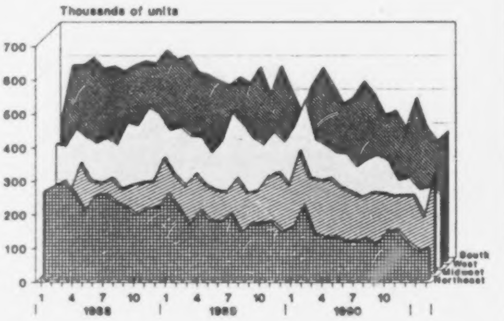
Source: Bureau of Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of the Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of Census

If it is true that the housing sector will lead the economy out of the recession, then February's impressive activity in the housing market is a good sign. Housing starts, for example, posted a 16.4 percent increase in February, reaching an annual rate of 989,000 units. This increase is the biggest monthly gain in over a year and more than reverses January's steep decline. Accounting for most of the increase, single-family starts were 18 percent above January's rate of 652,000 units. Multifamily starts rose 10.1 percent.

Starts nearly doubled in the Midwest from January's depressed levels. February's rate of 296,000 units is the highest rate in more than a year. In the South, starts totalled 384,000 units, an increase of 7.9 percent. The Northeast registered a 5.7 percent increase, bringing the rate of housing starts to 92,000 units. Only the West experienced a decline as starts fell by 9.6 percent to 217,000 units -- the lowest level since August 1982, during the 1981-82 recession.

The recent reports of increased interest from first-time home buyers attracted by lower mortgage rates is reflected in the forecast for the remainder of the year. With single-family homes accounting for 96 percent of the entire gain, total housing starts are expected to increase by 88,000 units in the second quarter of 1991. Single-family starts should continue to exhibit vigorous growth during the latter half of 1991. Total starts will grow by nearly 20 percent in 1992.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

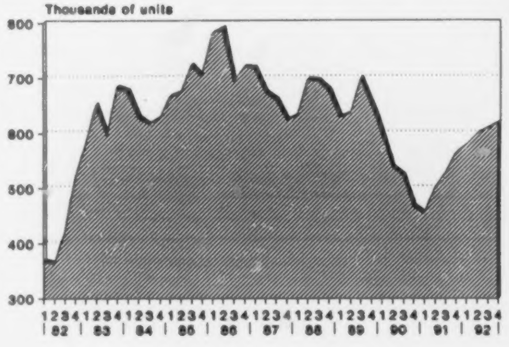
		Mo. Ago % Chg.	Yr. Ago % Chg.
Feb 1990	606	-3.3	-2.7
Mar 1990	559	-7.8	0.5
Apr 1990	534	-4.5	-12.5
May 1990	535	0.2	-17.8
Jun 1990	549	2.6	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	460	-4.2	-27.3
Jan 1991	402	-12.6	-35.9
Feb 1991	***467***	***16.2***	***-22.9***
Annual Averages:			
1989	654		-3.1
1990	532		-18.7

Regional Data

	Northeast	Midwest	South	West
Feb 1990	68	84	265	189
Aug 1990	63	88	236	138
Sep 1990	61	93	215	134
Oct 1990	74	70	209	113
Nov 1990	68	86	205	122
Dec 1990	63	84	194	120
Jan 1991	51	64	176	111
Feb 1991	***54***	***109***	***192***	***113***
Annual Averages:				
1989	90	103	258	202
1990	74	89	223	146
Percent Changes in Febuary 1991 since:				
Feb 1990	-20.6	29.8	-27.5	-40.2
Jan 1991	5.9	70.3	9.1	1.8

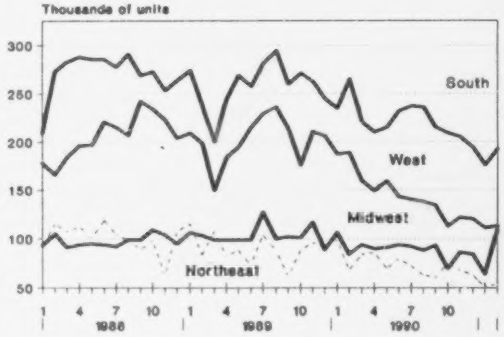
Source: Bureau of Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of the Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of Census

A renewed interest in homebuying in the latter half of January, noted by many REALTORS®, translated into an increase in new home sales for February. The month's new home sales were 16.2 percent higher than January's level of 402,000 units. A rebound in consumer confidence following the end of the Persian Gulf war together with lower mortgage rates attracted prospective homebuyers to the housing market.

On a regional basis, the Midwest recorded a 70.3 percent increase from January's dismal performance, bringing the sales rate to 109,000 units. The South recorded a 9.1 percent growth rate, with sales increasing to 192,000 units. In the Northeast, sales grew by 5.9 percent to 54,000 units. The West recorded modest growth, increasing 1.8 percent to 113,000 units.

Favorable financing conditions are expected to continue through 1991, and prospective homebuyers appear to be ready to take advantage of low mortgage rates. New home sales are expected to rally in the second quarter of 1991, increasing 10.6 percent to 502,000 units. Growth will continue throughout the year, with new home sales increasing by 5.4 and 6.8 percent in the third and fourth quarters of 1991, respectively. By the fourth quarter of 1991, new home sales are projected to be 111,000 units above the first quarter rate of 454,000 units. In 1992, new home sales are expected to reach a level of 601,000 units, an increase of 17.3 percent from 1991's level of 513,000 units.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

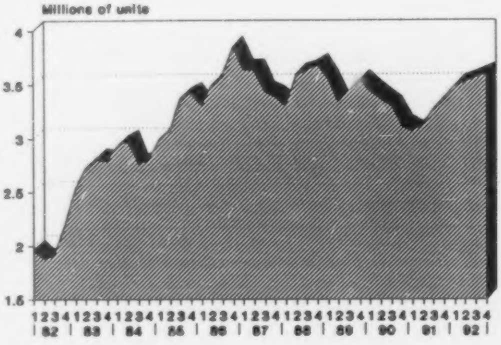
		Mo. Ago % Chg.	Yr. Ago % Chg.
Feb 1990	3,420	-1.4	-3.7
Mar 1990	3,440	0.6	0.3
Apr 1990	3,370	-2.0	-2.0
May 1990	3,350	-0.6	3.1
Jun 1990	3,370	0.6	1.2
Jul 1990	3,320	-1.5	-1.8
Aug 1990	3,410	2.7	-0.9
Sep 1990	3,160	-7.3	-10.0
Oct 1990	3,070	-2.8	-12.0
Nov 1990	3,150	2.6	-11.5
Dec 1990	3,130	-0.6	-12.1
Jan 1991	2,900	-7.3	-16.4
Feb 1991	***3,130***	***7.9***	***-8.5***
Annual Averages:			
1989	3,467		-2.5
1990	3,305		-4.7

Regional Data

	Northeast	Midwest	South	West
Feb 1990	550	930	1,310	640
Sep 1990	520	880	1,240	520
Oct 1990	500	820	1,240	500
Nov 1990	500	860	1,280	500
Dec 1990	500	880	1,260	490
Jan 1991	460	810	1,180	450
Feb 1991	***500***	***880***	***1,220***	***540***
Annual Averages:				
1989	597	931	1,320	617
1990	523	908	1,313	558
Percent changes in February 1991 since:				
Feb 1990	-9.1	-5.4	-6.9	-15.6
Jan 1991	8.7	8.6	3.4	20.0

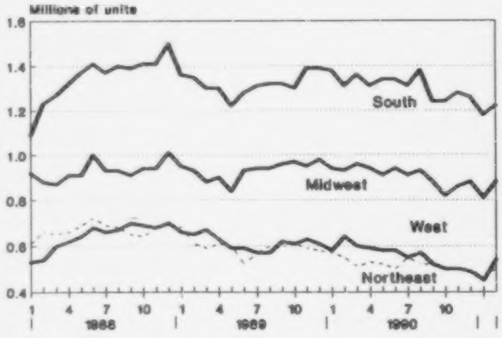
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

Falling home prices and lower mortgage rates brought buyers back into the marketplace in February. Sales of existing homes recorded their largest increase since April of 1986, increasing 7.9 percent to 3.13 million units. Nevertheless, February sales remain 8.5 percent below their year-ago sales rate.

Sales activity was up in every part of the country, with the Western region leading the rally. In that region, sales increased by 20 percent to an annual rate of 540,000 units. The Northeast, which has been dominated by sluggish sales in high-cost markets, posted an 8.7 percent increase, to an annual rate of 500,000 units. In the Midwest sales jumped 8.6 percent to 880,000 units. The South recorded a resale rate of 1.22 million units, up 3.4 percent from January.

The combined impact of lower mortgage rates and falling home prices has made homeownership more affordable to those with modest incomes, particularly the entry-level buyer. During the second quarter of 1991, sales are expected to be up, and by mid-summer the full impact of favorable mortgage rates should be reflected in a noticeably larger volume of purchases. By the fourth quarter of 1991, sales are projected to be 322,000 units above the first quarter's level of 3.06 million units. This will position the market for robust growth in 1992, when sales are expected to increase by 10.4 percent. An expanding economy and attractive mortgage rates in 1992 should put sales activity at its highest pace since 1988.

Single-Family Home Prices

(In Dollars)

National Data

	Median		Average	
	Existing	New	Existing	New
Feb 1990	95,100	126,900	118,200	150,900
Sep 1990	94,400	113,000	116,800	142,100
Oct 1990	92,900	120,000	115,900	153,000
Nov 1990	92,000	118,900	115,600	144,800
Dec 1990	91,700	127,000	114,100	153,900
Jan 1991	95,600	120,000	123,000	152,300
Feb 1991	***94,800***	***127,500***	***120,600***	***156,800***
Annual Averages:				
1989	92,900	120,400	118,000	148,300
1990	95,200	122,300	118,300	149,200
Percent changes in February 1991 since:				
Feb 1990	-0.3	0.5	2.0	3.9
Jan 1991	-0.8	6.3	-2.0	3.0

Regional Data

Median Prices for Existing Single-Family Homes

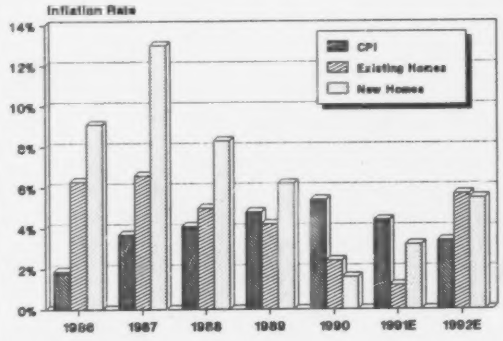
	Northeast	Midwest	South	West
Feb 1990	143,400	73,800	85,300	142,600
Sep 1990	137,100	74,200	85,900	134,700
Oct 1990	136,200	72,000	83,200	142,000
Nov 1990	134,200	71,800	83,500	139,600
Dec 1990	134,400	72,300	82,800	131,400
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	***137,700***	***76,000***	***84,000***	***141,500***
Annual Averages:				
1989	145,100	71,200	84,400	139,800
1990	141,300	73,700	85,700	139,700
Percent changes in February 1991 since:				
Feb 1990	-4.0	3.0	-1.5	-0.8
Jan 1991	0.6	2.0	-0.7	-5.4

Source: National Association of Realtors,® "Home Sales"

The national median existing single-family home price declined between January and February, making homeownership more affordable for prospective buyers. February's median price of $94,800 was 0.8 percent below January's price of $95,600 and 0.3 percent below the February 1990 price of $95,100. In the market for new homes, the median price increased 6.3 percent to $127,500 in February. The median price of a new home is 0.5 percent above last February's level of $126,900.

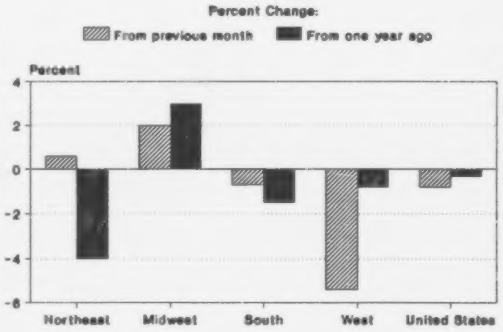
The average price of existing homes decreased by 2 percent in February, falling to $120,600. Since February 1990, the average price has risen 2 percent. An increase of 3 percent added $4,500 to the average price of a new single-family home.

Home Prices



Source: Bureau of the Census; E Real Estate Outlook forecast

Home Prices by Region



Source: NAR Economics & Research

Modest appreciation in the median price of existing single-family homes is expected over the next year, with an overall increase of 1.2 percent in 1991. Prices will begin to firm at year end, and are projected to increase 5.7 percent in 1992. New single-family home prices should experience slightly higher growth in 1991, with prices increasing by 3.2 percent. In 1992 the median price of new single-family homes will increase by 5.5 percent.

Robert D. Barr — *Kimberly A. Martin*
Director of Forecasting — *Research Economist*
Forecasting & Policy Analysis

FROM BOOM TO BUST AND BACK AGAIN:
The Influence of Tax Reform on the Value of Income-Producing Property

Introduction

Over the last 10 years, the real estate sector of the U.S. economy has been buffeted by a series of major tax policy changes including the 1981 Economic Recovery Tax Act (ERTA), the 1984 and 1985 Tax Reform Acts and the 1986 Tax Reform Act (TRA). The most significant tax reforms have been ERTA and TRA.

While ERTA is widely credited with having created the booming real estate markets of the 1980s, TRA is now generally blamed for having triggered a persistent depression in the housing sector of the economy that has spread to the general economy and wreaked havoc on the nation's financial system. The severity of this depression is attributable in a large part to the juxtaposition of these two major tax reforms, each of which had completely opposite effects on the housing markets.

What is more, many of the provisions of TRA that affected real estate investments applied not just to future investments but to most existing investments as well. As a result, the value of existing real estate investments declined sharply in many markets. After a brief review of major tax policy changes over the last decade, this paper uses standard cash flow analysis to examine the impact of four key tax code changes under TRA on the value of income-producing properties and discusses possible policy changes that could ameliorate three of these tax reforms which have hurt real estate investments.

While accounting and partnership changes affecting the financing of real estate investments were arguably very damaging to real estate and contributed significantly to the loss in value to commercial property, an analysis of their impact is beyond the scope of this paper. The cash flow analysis presented here simulates the impact of major provisions of TRA as they affect an individual investor, and not group investment programs.

Major Tax Policy Changes in the 1980s

A primary goal of ERTA, enacted in 1981, was to stimulate the economy. The act is perhaps best known for reducing the top marginal income tax rate from 70 to 50 percent. For taxpayers in the highest tax bracket, the cut in top tax rate reduced the benefit of itemized deductions such as the popular homeowner deductions for mortgage interest and property taxes.

However, ERTA also included provisions directly targeted to boost the housing sector of the economy. In addition to reducing the top marginal income tax rate, the act reduced the marginal tax rate on long-term capital gains for the highest-income investors from 28 percent to 20 percent, and shortened the tax lifetime for residential rental property from 32 to 15 years.

As a result, investment in housing and commercial real estate development increased significantly in many markets between 1981 and 1984. In fact, ERTA was so successful in boosting the real estate sector of the economy, Congress increased the tax lifetime for real property to 18 years in 1984 and to 19 years in 1985.

In 1986, the impact of the 1984 and 1985 tax acts was dwarfed by TRA which completely reversed most of the economic recovery provisions enacted in 1981 as part of ERTA. In contrast to ERTA, which lowered the maximum capital gains tax rate from 28 percent to 20 percent, TRA eliminated the distinction between capital gains and other types of income and raised the top marginal tax rate to 33 percent.

Moreover, TRA extended the tax lifetime to 27.5 years for residential properties and to 31.5 years for commercial properties and required straight-line depreciation rather than the faster 175 percent declining balance method. These less generous depreciation rules coupled with lower marginal income tax rates significantly reduced the value of depreciation tax benefits.

On top of these conventional changes, TRA created a new category of income called passive income. Under TRA, income is deemed passive if it is derived from the conduct of a trade or business and the taxpayer does not materially participate in the activity. The material participation rule is irrelevant in the case of rental real estate since all rental activities are considered passive activities.

Passive Loss Limitations Raise Cap Rates

According to the passive loss limitations rules, deductions from passive activities such as rental activities, to the extent they exceed income from such activities, generally may not be deducted from other income, such as salary and portfolio income. Taxpayers with less than $100,000 of adjusted gross income (AGI) are permitted to offset up to $25,000 of passive losses against nonpassive income. The $25,000 allowance is phased out gradually for taxpayers with AGIs above $100,000 until it is eliminated for those with AGIs above $150,000.

For taxpayers who have used up their respective allowance or who have AGIs in excess of $150,000, passive losses may only be used to offset passive income. In cases where passive losses exceed passive income, the excess losses are suspended and carried forward to offset passive income that might arise in subsequent years and, to the extent not used, are allowed to offset other income in the year a taxpayer disposes of his interest in the activity. Although investors in passive activities are permitted to offset passive losses eventually, they may have to sustain such losses for many years, and during this period they are denied any earnings from money tied up in the suspended losses.

In addition, the limitation on passive losses also raises the after-tax risk of rental projects, since it provides limited loss-offset in unprofitable projects. The higher risk associated with rental projects is translated immediately into higher capitalization rates for rental real estate projects. Moreover, the loss limitations also discourage high-leverage rental projects because the interest deductions in these projects are no longer as valuable to their investors.

Disincentives Contained in TRA Caused Abrupt Drop in Property Values

Almost overnight, the present values of most real estate projects plummeted when TRA was enacted. The results of standard cash flow analysis shown in Table I reveal how the present value of a typical residential rental property, operating before TRA, dropped more than 20 percent after TRA was enacted, assuming all other variables remained constant.

In fact, many other variables did not remain constant. For example interest rates and housing starts declined, which together probably reduced the impact of TRA on property values in some markets. Thus the following results from partial equilibrium simulations probably overstate the impact of TRA on property values in some markets, especially in those markets where the supply of vacant rental space has been relatively low. In other markets, however, where the supply of vacant rental space in the post-TRA period has remained high, the following simulation results may closely approximate the short-run impact on the value of income-producing properties.

Case 1 of Simulation I shown in Table I indicates that a residential rental property generating an average net income for such a property and subject to typical financing assumptions had an initial value of $7,447,345 and an after-tax internal rate of return (A/T IRR) of 33.1 percent before TRA. After TRA, this property under the same assumptions yields a projected A/T IRR of 16.2 percent as shown in case 5.

Because the actual A/T IRR is exogenously determined in the capital markets, however, the before-tax IRR and the value of the property are the only variables that can change in response to TRA. If it is assumed that rents are held in check by a large inventory of existing buildings and expenses remain unchanged, only the price of the property can change in the short run. Thus in order to maintain an unchanged A/T IRR of 33.1 percent, the value of the property after TRA drops 20.37 percent to $5,930,000 as shown in case 5.

Because many tax provisions were enacted simultaneously with TRA and since the effect of each of these provisions is interdependent with each of the other provisions, it is difficult to assess the precise effect of individual provisions on the present value of the property. Comparison of Simulation I and Simulation II shows that the measured effect of passive loss limits and 1986 depreciation rules depends on the order in which it is assumed such provisions are enacted.

In Simulation I, it is assumed that TRA is implemented one provision at a time beginning with a cut in the marginal income tax rate, then an increase in the capital gains rate, then application of passive loss limits and finally a change in depreciation rules. The reduction in marginal income tax rates by itself reduces the property's present value by 11.82 percent. Dropping marginal income tax rates and raising the top capital gains tax rate cause a 12.89 percent decline in present value. Applying passive loss limits in addition to all of the previous changes would reduce the property's present value by 20.19 percent, assuming that all passive losses must be carried forward to be offset against future passive income. As the final case shows, adopting all of the above tax changes plus the 1986 depreciation rule results in a 20.37 percent decline in the property's present value. From these results, it appears that the passive loss limits account for 7.3 percentage points (20.19%-12.89%)

of the 20.37 percent decline, or more than one third of the total decline.

Rearranging the order in which the tax provisions are implemented, however, significantly alters the apparent effect of each provision on the property's present value. For example, in Simulation II, the order of the tax provisions is the same except that the 1986 depreciation rule is assumed to be adopted before the passive loss limits are applied. Under this assumption, the depreciation rule accounts for 6.04 percentage points (18.93%-12.89%) of the 20.37 percent decline, representing slightly less than a third of the total decline.

The reason that the order in which passive loss limitations and new depreciation rules are adopted substantially alters their respective impact on the property's present value is that these two tax provisions are interdependent. The benefit of more rapid depreciation is smaller to the extent that passive losses can only be used to offset passive gains, since passive losses resulting from faster depreciation must be deferred. Moreover, the benefit of being allowed to offset ordinary income with passive losses is smaller to the extent that depreciation benefits are reduced, since more rapid depreciation, in many cases, is a major source of passive losses.

Although rearranging the order in which the tax provisions of TRA are implemented alters the apparent effect of each provision, the 20.37 percent total decline in the property's present value remains unaffected. This predicted decline in the property's present value, however, assumes that all passive losses are carried forward. The total decline would be slightly less to the extent that an individual is not fully constrained by the passive loss limits, either because he meets the qualifications required to be able to offset up to $25,000 of passive losses against active income and has not already used all of this allowance, or because he has sufficient net passive gains from other activities. However, most individuals undertaking an investment of this magnitude, on average, are likely to be fully constrained by the passive loss limitations.

Tax Policy Changes Affected Real Estate First, Then Savings and Loans

After nearly five years of priming the real estate pump, Congress suddenly reversed course in 1986, abruptly choking the industry. While it was conceded, at the time, that real estate investors would suffer losses as a result of TRA at first, it was argued that such losses would be at least partially offset by rising rents because the new tax laws would discourage new construction which, in turn, would force up rents of existing buildings. As it_turns out, however, the supply of existing buildings, has been sufficient to keep downward pressures on rents for many years.

With the rules changed virtually overnight and with only limited provisions included to apply the new tax laws gradually so as to allow investors time to adjust, investors suddenly found themselves having to swallow 15 to 20 percent declines in the values of their real estate portfolios. Reductions in project values of this magnitude were sufficient to push many marginal projects into insolvency.

Since, according to most sources, mortgages and mortgage-backed securities account for almost 86 percent of all savings and loan assets, the significant increase in real estate investment failures in turn reduced the solvency of many marginally solvent savings and loans. Thus, where Congress originally sought to bring the economy out of recession by boosting the housing sector, it eventually contributed to the current decline in the economy by hitting the housing sector abruptly with costly tax changes that significantly lowered asset values which, in turn, substantially exasperated an existing tightness in credit markets.

Reversing the Trend in Real Estate Prices

One of the basic underlying causes of the current credit crunch is the perception, justified or not, that real estate under current market conditions in many regions represents an inferior investment opportunity. The downward trend of real estate prices in many markets that had experienced sustained and rapid price appreciation has reduced expectations with respect to the future earning potential of real estate investments. In time, the market will eventually adjust to the radical changes in tax policy brought about by the Tax Reform Act of 1986 (TRA), resulting in a reduced supply of both residential rental and commercial buildings and higher rents. Given the severity of the shock to the industry caused by TRA, however, the adjustment period could be relatively long, causing persistent harm both to the banking sector and to the economy in general.

One option that could reduce this adjustment period would be to mitigate the severity of certain provisions of TRA as they affect real estate investments. As shown in the preceding simulations, the provisions that have reduced the value of commercial property the most include

TABLE I

INCREMENTAL EFFECTS OF SELECTED PROVISIONS OF 1986 TAX REFORM ACT ON THE VALUE OF A RESIDENTIAL RENTAL PROPERTY

BASIC ASSUMPTIONS:

Price	$7,447,345	Capitalization Rate	8.7%
Land Value As Percent of Price	15.0%	Initial Annual Operating Costs	$665,855
Furniture and Fixtures As Percent of Price	5.0%	Initial Annual Rents	$1,313,774
Structure As Percent of Price	80.0%	Growth Rate of Operating Costs and Rents	4.0%
Downpayment As Percent of Price	10.0%	Inflation	4.0%
Interest Rate	10.0%		

SIMULATION I: PASSIVE LOSS LIMITS APPLIED BEFORE DEPRECIATION RULE CHANGED

Case	Cumulative Changes to Pre-1986 Tax Law	Before Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	Present Value of Residential Rental Property Required to Yield A/T IRR Under Pre-1986 Tax Law	Cumulative Change in Present Value of Residential Rental Property to Yield A/T IRR Under Pre-1986 Tax Law
1	No Change	19.20%	33.10%	$7,447,345	0.00%
2	28 Percent Top Income Tax Rate	19.20%	23.80%	$6,567,345	-11.82%
3	28 Percent Top Capital Gains Tax Rate	19.20%	22.70%	$6,487,345	-12.89%
4	Passive Loss Limits Apply	19.20%	16.20%	$5,944,000	-20.19%
5	Depreciation Under 1986 Rule	19.20%	16.20%	$5,930,000	-20.37%

SIMULATION II: DEPRECIATION RULE CHANGED BEFORE PASSIVE LOSS LIMITS APPLIED

Case	Cumulative Changes to Pre-1986 Tax Law	Before Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	Present Value of Residential Rental Property Required to Yield A/T IRR Under Pre-1986 Tax Law	Cumulative Change in Present Value of Residential Rental Property to Yield A/T IRR Under Pre-1986 Tax Law
1	No Change	19.20%	33.10%	$7,447,345	0.00%
2	28 Percent Top Income Tax Rate	19.20%	23.80%	$6,567,345	-11.82%
3	28 Percent Top Capital Gains Tax Rate	19.20%	22.70%	$6,487,345	-12.89%
4	Depreciation Under 1986 Rule	19.20%	18.90%	$6,037,345	-18.93%
5	Passsive Loss Limits Apply	19.20%	16.20%	$5,930,000	-20.37%

Simulation results derived using planEASe Economic Analysis System.

those pertaining to the treatment of passive activity income, capital gains and depreciation rules. Table II reveals the cumulative impact of modifying these provisions on the value of the same typical residential rental property assumed in the previous simulations. While the number of ways the tax code can be changed is seemingly unlimited, for purposes of this study, three policy changes are considered: removal of passive loss restrictions; reduction of the maximum capital gains rate to the pre-TRA rate of 20 percent; reducing the depreciable life for real estate investments to the pre-TRA tax life of 19 years.

At first thought, it might seem that to make these three tax policy changes would be essentially to return to the pre-TRA tax treatment of real estate. However, the tax benefit of these tax policy changes would be considerably smaller today than they would have been before TRA because marginal income tax rates are substantially lower today than they were before TRA. In any case, the purpose of simulating the effects of these particular tax reforms is simply to indicate the sensitivity of a typical real estate investment's value to certain changes in tax laws, not to recommend specific tax code changes.

Simulation Results of Potential Tax Policy Changes

Three simulations are included to show the impact of each potential change in tax policy under different assumptions regarding an investor's marginal income tax rate. The 1990 tax act maintains the 28 percent tax bracket under previous law and establishes a new maximum tax bracket of 31 percent beginning at a taxable income of $49,300 for a single return and $82,150 for a joint return for 1991.

In addition to establishing a higher maximum rate, the act also imposes a reduction in the non-exempt itemized deductions in the amount of 3 percent of adjusted gross income (AGI) over $100,000 for single filers and married couples filing jointly. The reduction in non-exempt itemized deductions adds an additional 1 percentage point to the maximum marginal income tax rate for taxpayers with AGIs above $100,000. Thus the top marginal tax rate for some taxpayers is 32 percent.

The 1990 tax act also adds approximately 0.5 percent to a taxpayer's marginal tax rate for each personal exemption claimed if the taxpayer's AGI exceeds $150,000. As a result, a married couple with two children and AGI in excess of $150,000 could have a marginal tax rate of 34 percent. It is likely that the marginal investor in commercial real estate has a marginal income tax rate nearer 34 percent than 28 percent. To consider several possibilities, the marginal income tax rate is assumed to be 28 percent in Simulation I, 32 percent in Simulation II, and 34 percent in Simulation III.

If passive loss restrictions are removed, as assumed in case 2, the increase in the projected A/T IRR ranges from 2.7 percentage points in Simulation I to 3.3 percentage points in Simulation III. The change in the value of the property required to leave the actual A/T IRR unchanged ranges from 4.2 percent in Simulation I to 5.14 percent in Simulation III.

If in addition to removing passive loss restrictions, the top capital gains tax rate is lowered to the pre-TRA rate of 20 percent, as assumed in case 3, the value of the property would have to increase by at least 6.16 percent in Simulation I and by as much as 9.03 percent in Simulation III to leave the respective A/T IRRs unchanged. Combining these tax policy changes with a return to the pre-1986 depreciation rules, as shown in case 4, would result in a cash flow that would require at least a 10.78 percent increase in the property's value in Simulation I and a 15.10 percent increase in Simulation III to yield the respective actual A/T IRRs.

The Impact of Tax Reform on Capitalization Rates

If the passive loss restrictions are removed, investors in real property of this nature, which typically yields substantial losses until it is sold, will be more certain that they will be able to bear such sustained losses until a profit can be realized since they will be able to offset such losses against income from non-passive activity. Investors will no longer have to speculate whether they will be able to generate sufficient passive gains to offset passive losses as they occur. This reduction in uncertainty would reduce the riskiness of such an investment, which would result in a lower capitalization rate since a significant component of the capitalization rate is a risk premium.

The lower capitalization rate, in turn, would result in a higher property value given that property value is equal to the flow of income net of expenses discounted by the capitalization rate. Case 5 shows that the increase in value of this property could range from 11.85 percent in Simulation I to 18.20 percent in Simulation III if in conjunction with all of the above tax policy changes, the capitalization rate were to fall from its current rate of 8.7 percent to 8.2 percent.

TABLE II

INCREMENTAL EFFECTS OF SELECTED TAX POLICY CHANGES ON THE VALUE OF A RESIDENTIAL RENTAL PROPERTY

BASIC ASSUMPTIONS:			
Price	$7,447,345	Capitalization Rate	8.7%
Land Value As Percent of Price	15.0%	Initial Annual Operating Costs	$665,855
Furniture and Fixtures As Percent of Price	5.0%	Initial Annual Rents	$1,313,774
Structure As Percent of Price	80.0%	Growth Rate of Operating Costs and Rents	4.0%
Downpayment As Percent of Price	10.0%	Inflation	4.0%
Interest Rate	10.0%		

SIMULATION I: ASSUMING 28 PERCENT MARGINAL INCOME TAX RATE

Case	Cumulative Changes to 1990 Tax Law and Basic Assumptions	Before Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	Present Value of Residential Rental Property Required to Yield A/T IRR Under 1990 Tax Law	Cumulative Change in Present Value of Residential Rental Property to Yield A/T IRR Under 1990 Tax Law
1	No Change	19.20%	16.20%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.20%	18.90%	$7,760,000	4.20%
3	20 Percent Top Capital Gains Tax Rate	19.20%	20.00%	$7,906,000	6.16%
4	Pre-1986 Depreciation Rule	19.20%	23.80%	$8,250,000	10.78%
5	Cap. Rate Falls from 8.7% to 8.2%	19.20%	24.30%	$8,330,000	11.85%

SIMULATION II: ASSUMING 32 PERCENT MARGINAL INCOME TAX RATE

Case	Cumulative Changes to 1990 Tax Law and Basic Assumptions	Before Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	Present Value of Residential Rental Property Required to Yield A/T IRR Under 1990 Tax Law	Cumulative Change in Present Value of Residential Rental Property to Yield A/T IRR Under 1990 Tax Law
1	No Change	19.20%	16.20%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.20%	19.30%	$7,810,030	4.87%
3	20 Percent Top Capital Gains Tax Rate	19.20%	20.60%	$7,980,000	7.15%
4	Pre-1986 Depreciation Rule	19.20%	25.21%	$8,410,000	12.93%
5	Cap. Rate Falls from 8.7% to 8.2%	19.20%	26.51%	$8,610,000	15.60%

SIMULATION III: ASSUMING 34 PERCENT MARGINAL INCOME TAX RATE

Case	Cumulative Changes to 1990 Tax Law and Basic Assumptions	Before Tax Internal Rate of Return (IRR)	Projected After-Internal Rate of Return (A/T IRR)	Present Value of Residential Rental Property Required to Yield A/T IRR Under 1990 Tax Law	Cumulative Change in Present Value of Residential Rental Property to Yield A/T IRR Under 1990 Tax Law
1	No Change	19.20%	15.50%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.20%	18.80%	$7,830,000	5.14%
3	20 Percent Top Capital Gains Tax Rate	19.20%	20.90%	$8,120,000	9.03%
4	Pre-1986 Depreciation Rule	19.20%	26.00%	$8,570,000	15.10%
5	Cap. Rate Falls from 8.7% to 8.2%	19.20%	27.30%	$8,800,000	18.20%

Simulation results derived using planEASe Economic Analysis System.

Summary and Conclusions

This study simulated the impact of TRA on real property values assuming that a large inventory of buildings would increase the time period required for rents to adjust fully. Using standard cash flow analysis, it was shown that TRA may have reduced the value of investment property by as much as 20 percent in some markets. In addition, it was revealed that certain changes in tax policy could increase investment property values by between roughly 12 and 18 percent. It was found that removing passive loss restrictions, reducing the capital gains tax rate to 20 percent and shortening the recovery period or tax life of investment property to the period under pre-1986 rules could increase property values by between approximately 11 and 16 percent. Moreover, it was shown that if capitalization rates fall by 0.5 percent as a result of such tax policy changes, the total increase in property value could rise additionally by between 1 and 3 percent.

Cash flow analysis shows that certain changes in tax policy can increase the value of real property substantially. Rising real estate values, in turn, could increase the willingness of lenders to continue to underwrite real estate projects. The improved tax environment coupled with easier access to credit could substantially reduce the adjustment period required for the real estate sector to recover from the effects of TRA.

by

Donald R. Leavens, Ph.D.
Director, Tax Research
Forecasting and Policy Analysis Division

TAX-DEFERRED SAVINGS AND FIRST-TIME HOMEBUYERS

The idea of using tax-deferred retirement savings for first-time home purchases has been around for several years among lawmakers. This year, liberalizing individual retirement accounts (IRAs) is back on the agendas of both Congress and the Administration. For the second year in a row, the President has proposed to waive a penalty tax on early IRA withdrawal for first-time home purchases. In Congress, bills allowing the use of IRA contributions for downpayment on a home have been reintroduced. While some people are convinced that some IRA-home-purchase bill will be passed this year, others are more pessimistic citing that the new pay-as-you-go budget process would make it more difficult for Congress to cut back existing programs to pay for a new venture.[1]

Restrictions on IRAs

Currently, individuals who are not covered by any pension plans are allowed to deduct IRA contributions of up to $2,000 a year from their ordinary income, regardless of their income level. Accumulated interest income from an IRA is tax-deferred until the IRA funds are withdrawn. Upon retirement, all distributions of funds and earnings from an IRA are fully taxable as ordinary income. Although the principal and interest in IRAs are only tax-deferred and not tax-free, IRAs would benefit enrollees whose marginal tax rates are lower during retirement years than during working years when contributions are made.

The Tax Reform Act of 1986 (TRA) reduced allowable IRA deductions for higher-income taxpayers if the taxpayers or their spouses are covered by their employers' retirement plans. The limits on deductible contributions are gradually phased out between adjusted gross income (AGI) of $25,000 and $35,000 for single taxpayers, and between $40,000 and $50,000 for married couples. The phase-out ranges are not indexed for inflation, and therefore fewer taxpayers are eligible for the deductions each year.

IRA funds do not make a good substitute for saving for purposes other than retirement. If IRA holders withdraw the funds prior to reaching age 59½, they are subject to a 10-percent penalty tax in addition to the regular federal and state income taxes. For example, an individual who pays federal, state and local taxes at a combined 35-percent rate would be left with only $550 from a $1,000 IRA withdrawal after paying the income tax and the 10-percent penalty tax.

Effects of TRA on IRA Contributions

After the curtailment of IRA eligibility following TRA, the rate of enrollment in IRA arrangements fell by about 40 percent in 1987. Two reasons can explain the sharp decline in IRA participation. First, IRA participation is commonly believed to be positively related to marginal tax rates.[2] Since TRA reduced the top marginal tax rate from 50 to 33 percent and thus reduced the benefit of deferring taxes, a decline in IRA participation was expected. Moreover, IRA deductibility was phased out for higher-income taxpayers and therefore further reduced the tax advantage of IRAs for those with AGIs in the phase-out ranges and beyond.

Table 1 shows the numbers of returns with IRA contributions and the respective amount of IRA contributions from 1980 to 1987, the last year data are available from the Internal Revenue Service. The proportion of the taxpayers contributing to IRAs fell dramatically from 15.1 percent in 1986 to 9.1 percent in 1987. In terms of the dollar amount, IRA contributions fell by 62 percent, from $37.8 billion in 1986 to $14.1 billion in 1987.

Table 1
IRA Contributions, 1980-87

		Individual Retirement Contributions	
Year	Total Returns	# of Returns	Amount ($ 000)
1980	93,902,469	2,564,421	3,[illegible]0,894
1981	95,396,123	3,415,053	4,[illegible]
1982	95,337,432	12,010,038	28,275,852
1983	96,321,310	13,613,167	32,060,627
1984	99,438,708	15,232,856	35,374,424
1985	101,660,287	16,205,846	38,211,574
1986	103,045,170	15,535,531	37,758,393
1987	106,996,270	9,743,574	14,065,725

Source: Individual Income Tax Returns, Internal Revenue Service.

Table 2 shows that IRA contributions fell across all income levels after TRA. Because the

Table 2
IRA Contributions by AGI Levels
1986 and 1987

AGI ($ 000)	1986 # of Returns	1986 $ Amount	1987 # of Returns	1987 $ Amount
0-5	169,678	303,932	120,386	174,979
5-10	435,137	704,257	350,775	503,796
10-15	738,610	1,352,150	634,427	949,878
15-20	1,030,570	1,894,216	802,419	1,227,931
20-25	1,288,043	2,495,415	1,072,520	1,612,699
25-30	1,423,249	2,878,093	1,202,163	1,683,807
30-40	2,856,177	6,417,511	2,355,873	3,368,085
40-50	2,486,702	6,273,939	1,687,075	1,882,050
50-75	3,101,528	9,107,840	820,097	1,411,955
75-100	971,558	3,083,499	305,719	550,648
100-200	793,654	2,507,101	293,058	524,025
200-500	190,442	582,889	81,074	144,116
500-1,000	36,151	116,376	12,163	21,423
1,000+	14,032	41,174	5,825	10,333

Source: Individual Income Tax Returns, Internal Revenue Service.

phase-out of the deduction is tied to the AGI levels and the reduction in the marginal tax rate reduced tax incentive for individuals at higher-income levels more than those at lower-income levels, as expected, the declines in IRA participation and contributions were more pronounced at the higher-income levels. For example, in 1987, the number of enrollees with AGI between $25,000 and $50,000 fell about 22.4 percent, compared to 73.5 percent for those with AGI between $50,000 and $75,000.

In terms of the dollar amount of IRA contributions, the amount fell 55.4 percent for those enrollees with AGI between $25,000 and $50,000 and 84.5 percent for those with AGI between $50,000 and $75,000. Thus, the phase-out of IRA deductibility for higher-income taxpayers changed the distribution of IRA contributions by AGI levels considerably.

Table 3 compares the distribution of IRA contributions by showing the percent of dollar amounts of IRAs contributed by enrollees for each AGI level and also the cumulative percent of IRA contributions for individuals at each AGI level. In 1986, about 59 percent of IRA contributions came from enrollees with AGIs of $50,000 or less (two-thirds of IRA enrollees). In 1987, as much as 81 percent of IRA contributions came from enrollees with AGIs of $50,000 or less (84.4 percent of enrollees).

Table 3
IRA Distribution, 1986 and 1987

AGI ($ 000)	1986 % of Total $ Added to IRAs	1986 Cum %	1987 % of Total $ Added to IRAs	1987 Cum %
0-5	0.80	0.80	1.24	1.24
5-10	1.87	2.67	3.58	4.83
10-15	3.58	6.25	6.75	11.58
15-20	5.02	11.27	8.73	20.31
20-25	6.61	17.88	11.47	31.77
25-30	7.62	25.50	11.97	43.75
30-40	17.00	42.50	23.95	67.69
40-50	**16.62**	**59.11**	**13.38**	**81.07**
50-75	24.12	83.23	10.04	91.11
75-100	8.17	91.40	3.91	95.02
100-200	6.64	98.04	3.73	98.75
200-500	1.54	99.58	1.02	99.77
500-1,000	0.31	99.89	0.15	99.93
1,000+	0.11	100.00	0.07	100.00

Source: Individual Income Tax Returns, Internal Revenue Service.

IRAs as an Incentive for Saving

A major debate among economists about IRAs is whether IRAs create new saving or merely shift assets from taxable investments, such as money market mutual funds, into the tax-deferred IRAs. Some critics argue that IRAs are only an instrument to allow taxpayers to shuffle many of the assets in their portfolios into IRAs to defer paying taxes and thus IRAs do not significantly create new saving. For example, Alan Auerbach, Professor of Economics at the University of Pennsylvania who recently joined the Joint Tax Committee to perform economic and revenue analyses, commented that no clear evidence exists that IRAs significantly increased saving during the period 1981 to 1986.[3]

If in fact IRA deposits merely represent a "reshuffling" of old saving into IRAs to minimize tax liabilities, they could cause a loss in Treasury revenue in the form of reduced tax revenue on interest income. Some economists believe that IRAs reduced national saving by reducing government saving (increasing the deficit from reduced tax revenue) with no offsetting increase in private saving between 1982 and 1986.[4]

Other economists, however, present evidence that IRAs had a net positive effect on new savings. Using a sophisticated econometric technique, Venti and Wise (1986, 1987, 1988) estimated that for every dollar being put in an IRA by an individual, most of it came from reduced consumption and reduced tax liability and less than 20 cents came from other taxable forms of saving. This implies that the new saving induced by IRA incentives outweighed the tax loss to the government.

Using the IRAs/University of Michigan taxpayer sample for income tax returns between 1980 and 1984, Feenberg and Skinner (1989) followed a group of families over the five-year period and monitored their assets portfolios. Their hypothesis is that if IRA contributions came from withdrawals from other taxable assets, the taxable asset income of IRA enrollees should have grown noticeably less than that for non-enrollees. In fact, they found the opposite result in that individuals who purchased IRAs in each year between 1982 and 1984 increased their asset holdings by more than those who did not purchase IRAs. Thus, they came to the same conclusion as Venti and Wise that IRAs represented new saving.

IRAs and Revenue Loss to the Treasury

The debate on the effect of IRAs on net saving has an important implication on the revenue loss of the IRA program. If taxpayers in fact shuffle proceeds from existing taxable accounts to the tax-deferred IRAs, revenue loss from forgone tax on interest will occur as a result of IRA incentives. However, if saving would not have occurred in the absence of the tax incentives of IRAs, i.e., if IRAs induce new saving, the Treasury would not lose any revenue from any forgone tax on interest since, without IRA tax incentives, no interest would exist to be taxed in the first place.

In a case where IRAs promote new saving, the deductibility of the principal of an IRA would not cause a permanent loss for the Treasury, rather only a short-term loss. That is, over the life of an IRA, say 30 years, no revenue loss would occur from allowing the contributions to be deductible as long as the taxpayer's marginal tax rate remains the same. The principal amount that is deductible up front will be taxed at a later date, by which time it will have grown considerably with interest. In effect, the government forgoes collection of the tax on the contribution up front and collects a larger amount of tax on a larger, compounded sum upon withdrawal at a later date.

Even if IRAs do not reduce the value over time of taxes collected by the Treasury, they shift the tax revenue from the present to the future and therefore represent a loss in each year's budget calculation. Some analysts argue that, in the long term, as the IRA program matures and more participants begin to withdraw funds from their IRAs, the deferred taxes will be paid and revenue collected will outweigh the amount deducted from new contributions and therefore IRAs will not be a revenue-loser over time.[5]

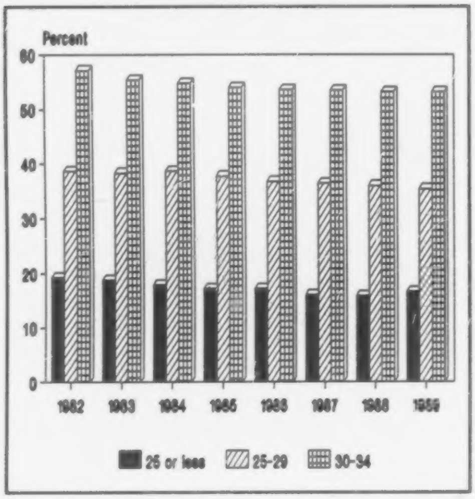
First-Time Homebuyers and Downpayment Constraint

The premise for tapping IRAs for home purchase is that first-time homebuyers have a difficult time saving for downpayments. As evidence, proponents for using IRAs for home purchase point to the declining homeownership rate in the United States, which peaked in 1980 with 65.6 percent of households being homeowners and fell to 63.9 percent in 1989. The decline, they argue, was even more dramatic among younger householders.[6]

Figure 1 shows Bureau of the Census data for the homeownership rates for young householders up to the age of 34.[7] For example, for those households in the 25-29 age group, 38.6 percent owned their own homes in 1982. By 1989, only 35.3 percent owned their homes. The same trend is evident for householders less than 25 years of age and for those between 30 to 34 years old, the age group most likely to be potential first-time homebuyers.

Not everyone agrees that the decline in the homeownership rate was caused by difficulty of saving for a downpayment for young households. Some analysts argue that homeownership rates fell

Figure 1
Homeownership Rates
34 Years Old or less, 1982-89



because households were simply making a rational investment and consumption choice. According to these analysts, as price appreciation slowed down and the tax benefits were reduced because of the drop in marginal tax rates, homeownership was viewed as less attractive than other types of investment. Therefore households may have preferred to rent rather than to own and to invest the potential downpayment in other investment assets.[8]

The notion that young renters have a difficult time saving for downpayments is reinforced by the 1986 Federal Reserve Board Survey of Consumer Finance. The survey represents 11.1 million renter households between the ages of 25 and 34. In an analysis by Denise DiPasquale (1989), 81.2 percent of those renters did not have the saving necessary to meet a 20-percent downpayment on the typical starter home while 64.3 percent of renters did not have the income to qualify for an 80 percent loan-to-value ratio mortgage. Only 11.5 percent of renter households had both the income and the savings that would be necessary to buy the typical starter home.

First-Time Homebuyers and IRAs

Evidence exists that potential first-time homebuyers did not participate heavily in tax-deferred saving programs. According to the Survey of Income and Program Participation in 1984, only 10.3 percent of households under the age of 35 had IRAs and only 8.5 percent of renter households had IRAs.[9] The figures improve for young renters with higher income. Data from the 1983 and 1986 Surveys of Consumer Finances also revealed that, for renters in the age of 25 to 34 earning at least $20,000, 20 percent had IRAs while 17.5 percent had 401(k) accounts.[10] Therefore IRAs may appear to provide little benefit to potential first-time homebuyers directly and thus lead some critics to argue that allowing penalty-free withdrawal from IRAs is "of no value to people of the lowest income."[11]

Others have a different view. They argue that the idea of using IRAs for home purchase is still beneficial to first-time homebuyers because IRAs could provide an incentive to potential homebuyers to start saving for a home by contributing to IRAs.[12] To accommodate young renters who do not have IRAs, some IRA proposals, such as the Bentsen-Roth bill, (S. 612), would permit IRA holders to withdraw their contributions for purchasing homes for their children and grandchildren as well as for themselves.

The President's IRA Proposal and Family Savings Account

The President's budget proposal sent to Congress in February would permit qualified first-time homebuyers to withdraw up to $10,000 from their IRAs without penalty. The price of the home must be no more than 110 percent of the community's median price. Although homebuyers would not incur the 10 percent penalty on early withdrawals, they would still owe income taxes on the sum withdrawn.

The President also proposed a saving program called the Family Saving Account. Taxpayers would be allowed non-deductible contributions of up to $2,500 annually. To qualify, a single person would have to earn less than $60,000 a year, $120,000 a year for a couple. The earnings of these accounts are tax-free if the principal is left in the account for more than seven years.

Penalty-Free IRA Proposals on the Hill

Several bills allowing penalty-free withdrawal from IRAs to purchase homes for first-time homebuyers have been introduced on the Hill this year. In the Senate, such bills have been introduced by Senator Donald W. Riegle, Jr., D-Mich., (S. 307) and Senators Lloyd Bentsen, D-Texas, and William V. Roth, Jr., R-Del. On the House side, bills that would waive a penalty tax for early IRA withdrawal for a first-time home purchase have been introduced by Rep. Robert Matsui, D-Calif., (H.R. 1114) and Rep. Marge Roukema, R-N.J., (H.R. 1352). An identical bill to the Bentsen-Roth bill has been introduced by Reps. J.J. Pickle, D-Texas, and William Thomas, R-Calif, (H.R. 1406).

The Bentsen-Roth "Super IRA" Plan

With 75 cosponsors in the Senate, enough to override the President's veto if necessary, the Bentsen-Roth IRA bill introduced last month seems to have a better chance than any other IRA bills this year. The Bentsen-Roth bill is more elaborate than other IRA bills currently introduced in Congress. The bill would restore the tax deduction for IRAs; that is, the tax deduction would be extended to all taxpayers, regardless of income or whether or not they are covered by employers' retirement plans.

The bill would also give individuals an option to contribute into a new "back-loaded" or non-deductible IRA dubbed "Super IRA," which is similar to the President's tax-free Family Savings Account. The contribution to the new account would not be deductible, but, withdrawals of IRA contributions and earnings are tax-free after assets have been held for five years.

Under both the up-front and back-loaded plans, taxpayers would be permitted to make penalty-free withdrawals of IRA contributions before retirement for the purpose of a first-home purchase, education expenses and catastrophic medical expenses. The medical expenses incurred by a taxpayer or a dependent must exceed 7.5 percent of the taxpayer's AGI in order to qualify for a waiver in the penalty tax. IRA holders are allowed to withdraw the funds for first-time home purchase and education expenses for their children or grandchildren as well.

Taxpayers could opt to contribute up to $2,000 a year to either plan or a combination of the two. The $2,000 amount would be indexed for inflation, with minimum $500 adjustment. Unlike other IRA bills, this bill would allow taxable but penalty-free withdrawals from other pension plans as well. For example, funds from 401(k) and 403(b) plans, which are tax-deferred savings arrangements sponsored by employers, could be withdrawn without penalty to be used for the same purposes allowed for IRA withdrawal.

Cost of the Penalty-Free IRA Bills

The proposals to waive a penalty on IRA withdrawal for certain purposes would cause revenue loss from the penalty tax forgone. The cost of the President's proposal is estimated to be $440 million over five years.[13] The Joint Tax Committee on taxation is preparing a cost estimate of the Bentsen-Roth bill; however, estimates given by various sources are as low as several million dollars and as high as $15 billion to $20 billion over a five-year period.[14]

Conclusions

Both the Administration and Congress generally agree on liberalizing IRAs to permit penalty-free withdrawal from IRAs for the purchase of homes for first-time homebuyers. The Administration, however, has intended to keep retirement saving objectives separate from other policy goals. For example, the Administration refused to support bills to allow penalty-free IRA withdrawals for troops serving in the Persian Gulf and has opposed to the Bentsen-Roth Super IRA plan.[15] The reason first-home purchase is an exception to the goal of supporting retirement savings, the Administration argued, is that a home is viewed as an integral part of retirement assets.

The price tag of these IRA bills is also a concern for both the Administration and Congress. Given the pay-as-you-go approach in the new budget process, revenue-losing proposals must be offset by commensurate increases in revenues or cuts in other programs. Senator Bentsen promised that the Bentsen-Roth IRA bill would not leave the Finance Committee unless it is revenue-neutral. Both Senators Bentsen and Roth reportedly have come up with possible sources of revenue to pay for the plan although they would not reveal them until they have its cost estimate.

by

Orawin T. Velz, Ph.D.
Tax Economist
Forecasting and Policy Analysis Division

Patrick W. Fleenor
Research Assistant

Endnotes

[1] Lehman (1991).

[2] See, for example, Feenberg and Skinner (1989), Long (1988, 1990) and O'Neil and Thompson (1987).

[3] Testimony to the House Budget Committee on February 1990, see *Tax Notes*, Vol. 50, No. 11, March 18, 1991, p. 1301.

[4] See, for example, Burman, Cordes and Ozanne (1990).

[5] Ture and Entin (1989).

[6] See, for example, DiPasquale (1990).

[7] *Homeownership Trend in the 1980's* (1990).

[8] See, for example, Liscio (1990).

[9] DiPasquale (1990), p. 5.

[10] The figures are calculated from *1983 and 1986 Surveys of Consumer Finances*, Board of Governors of the Federal Reserve System, unpublished data, see Schwartz (1990).

[11] Henry J. Aaron, Director of Economic Research at the Brookings Institution was quoted in the *National Journal*, No. 11, March 16, 1991, p. 364.

[12] See, for example, DiPasquaie (1990).

[13] *Budget of the United States Government: Fiscal Year 1992* (1991).

[14] The lower-end estimate, given by an anonymous Senate aide, was approximately $400 million over five years, see Lehman (1991). The upper-end estimate is provided by Richard A. Grafmeyer, Finance Committee minority tax council, to the members of the Employers Council on Flexible Compensation in March for the cost of Super IRA alone, see *Tax Notes*, Vol. 50, No. 11, March 18, 1991, p. 1187.

[15] Thomas Terry, Benefits Tax Counsel at the Treasury Department, said that the Bush Administration opposes the Super IRA plan at a meeting co-sponsored by the American Academy of Actuaries, the Conference of Actuaries in Public Practice and the Society of Actuaries on March 14, see *Tax Management Weekly Report*, Vol. 10, No. 11, March 18, 1991, p. 284.

References

Burman, Leonard, Joseph Cordes and Larry Ozanne, "IRAs and National Savings," *National Tax Journal*, Vol. XLIII, No. 3, September 1990, pp. 259-83.

DiPasquale, Denise, "Tax Deferred Savings for Homeownership," *Housing Roundtable Viewpoints*, Proceedings of a Public Forum in San Antonio, Texas, January 25, 1990.

________________ *The State of the Nation's Housing 1989*, Joint Center for Housing Studies of Harvard University, 1989.

Feenberg, Daniel, and Jonathan Skinner, "Sources of IRA Saving," National Bureau of Economic Research, Working Paper No. 2845, February 1989.

Lehman, H. Jane, "Congress Again Mulls Use of IRAs by First-Time Buyers," The *Washington Post*, February 16, 1991.

Liscio, John, "Gimme Shelter: Okay, but Should You Buy or Rent?," *Barron's*, May 21, 1990.

Long, James E., "Taxation and IRA Participation: Re-examination and Confirmation," *National Tax Journal*, Vol. XLI, No. 4, December 1988, pp. 585-90.

______________"Marginal Tax Rates and IRA Contributions," *National Tax Journal*, Vol. XLIII, No. 2, June 1990, pp. 143-54.

O'Neil, Cherie J., and G. Rodney Thompson, "Participation in Individual Retirement Accounts: An Empirical Investigation," *National Tax Journal*, Vol. XIII, No. 2, December 1987, pp. 617-24.

Schwartz, Mary B., "First-time Homebuyer Affordability: A Look Behind, A Look Ahead," NATIONAL ASSOCIATION OF REALTORS® *Research Paper*, Washington, D.C., February 1990.

Ture, Norman B., and Stephen J. Entin, *Save,* *America: A Primer on U.S. Saving and Its Effect on Economic Health*, The Institute for Research on the Economics of Taxation, Washington, D.C., 1989.

Venti, Steven F., and David Wise, "Tax Deferred Accounts, Constrained Choice and Estimation of Individual Saving," *Review of Economic Studies*, August 1986, pp. 579-601.

________________________"IRAs and Saving," in *Taxes and Capital Formation*, Martin Feldstein, ed., Chicago: University of Chicago Press and the National Bureau of Economic Research, 1987.

________________________"The Evidence on IRAs," *Tax Notes*, January 25, 1988.

Budget of the United States Government: Fiscal Year 1992, U.S. Government Printing Office, Washington, D.C., 1991.

Internal Revenue Service Statistics of Income -- 1986 Individual Income Tax Returns, Washington, D.C, 1989.

Internal Revenue Service Statistics of Income -- 1987 Individual Income Tax Returns, Washington, D.C, 1990.

Homeownership Trend in the 1980's, U.S. Bureau of the Census, Series H-121, No. 2, U.S. Government Printing Office, Washington, D.C., 1990.

CHECKING THE NATION'S VITAL SIGNS:
Home Ownership Affordability Measures

In the first article of this series ("Checking the Nation's Vital Signs: NAR Housing Affordability Indices," *Real Estate Outlook*, March 1991), we looked at several instruments used by the NATIONAL ASSOCIATION OF REALTORS® to measure the affordability of home ownership to individual prospective home buyer households.

The affordability of home ownership to individual households evidenced in the NAR and other AIs has important implications for the affordability of housing markets. Other indices assess housing affordability from a market perspective; that is, what percentage of households within a market can afford the median-priced home (California Association of REALTORS® Housing Affordability Index)? or what percentage of homes can the median income household afford in a particular market (National Association of Home Builders Relative Affordability Index)?

The first section of this article will briefly revisit the NAR Affordability Indices and highlight how State Associations and Local Boards of REALTORS® have tailored the NAR methodology of computing home ownership affordability to the special conditions encountered by the prospective home buyers there.

The second section will look at market indices of home ownership affordability. While not technically indices, one completed and one forthcoming study examine home ownership affordability from a market perspective by estimating the share of households that can afford a home. The second section will look at these studies as well.

Measures of Affordability of Home Ownership to Individual Households Using NAR AI Approach

The NATIONAL ASSOCIATION OF REALTORS® Affordability Indices (AIs) measure the ability of the median income family to qualify -- based on the share of its pretax income required to meet the payment -- for a mortgage loan on the median-priced home. NAR calculates its AIs for the nation, the four Census regions -- Northeast, South, Midwest, and West -- and select metropolitan areas. Home prices for NAR's AIs are derived primarily from selected metropolitan areas, making an index based on them less meaningful to some State Associations and Local Boards of REALTORS®. Home prices and median incomes used in the NAR AIs may not accurately reflect the market conditions of their respective areas.

Many State Associations and Local Boards of REALTORS® have adopted the NAR formula:

$$AI = \frac{\text{Median Family Income}}{\text{Qualifying Income}} \times 100$$

A value of 100 or more means the median income family is financially qualified to obtain a mortgage on the median-priced home, based on a 25 percent maximum principal and interest payment-to-income convention.

The chief difference between the NAR AIs and individual State Associations' and Local Boards' AIs is that the median-priced home and the median family income reflect economic conditions that are closer to home, and give a truer picture of the affordability of home ownership for their state, or even specific areas within their state.

Tailoring the index also allows some comparison between the market conditions of the localities to regional and national conditions. The relationship, e.g, higher or lower, between the NAR AI and a state or local index is a good indicator of the affordability of a local market relative to the nation as a whole. Comparison of *actual magnitudes* of the NAR AIs with others, however, should be done cautiously. For in many cases, sampling procedures for home sales differ among the NAR AIs and the affordability indices of the State Associations and Local Boards. This difference in sampling procedure often results in a different mix of homes sold. The characteristics of the median-priced home from the NAR sample, used in calculating qualifying income, may differ significantly from the characteristics of the median-priced home used in the calculations of other indices.

The Kentucky Association of REALTORS® Housing Affordability Index (KHAI) and First-Time Home Buyer Affordability Index (FHAI) parallel the NAR Indices for all home buyers combined and first-time home buyers, respectively, tailored to the unique conditions of a largely rural state.[1] (See Exhibit 1).

For the fourth quarter 1989, the KHAI is nearly one-third higher than NAR's Composite AI for the United States (average of October, November, December 1990) -- 141 versus 108 -- owing to relatively inexpensive housing coupled with good incomes. (See Table 1). Unfortunately, the KHAI and FHAI are currently unavailable as ongoing series, so comparison to previous quarters is not possible.

Table 1

HOUSING AFFORDABILITY INDICES:
NAR AND STATE ASSOCIATIONS OF REALTORS®

	4th Qtr. 1989	3rd Qtr. 1990	4th Qtr. 1990
NATIONAL ASSOCIATION OF REALTORS®	108	107.6	114.9
State Association Indices:			
Indiana	157	NA	NA
Kentucky	141	NA	NA
New York State	98	95	99.9
Wisconsin	145.1	146.1	154

The New York State Association of REALTORS® (NYSAR) also calculates an Affordability Index using the NAR methodology. (See Exhibit 1). Rising incomes, stable home prices, and declining interest rates contributed to increases in the fourth quarter 1990 NYSAR affordability index over the previous quarter (99.9 compared to 95), and over the fourth quarter of 1989 (99.9 compared to 98). A comparison of the NYSAR Index for fourth quarter 1990 of 99.9 to the NAR Composite Index for the United States of 114.9 suggests that New York is an expensive housing market relative to the nation as a whole. (See Table 1). Many of the Local Boards in New York, including Rochester, Westchester County, Ithaca, Buffalo, and Albany, calculate their own affordability indices based on the NAR methodology.

The Indiana Association of REALTORS® has a state index (IHAI) and indices reflecting affordability conditions in each of 19 major regions within the state. The association also computes a first-time home buyer index for the state as a whole. As in many markets, affordability in Indiana has been increasing recently, and the affordability index stood at 160 during the first quarter of 1990, up from 157 during fourth quarter 1989. A comparison of the fourth quarter 1989 IHAI to the NAR AI of 108 reveals that, relative to the nation, Indiana is quite affordable. (See Table 1).

The Wisconsin REALTORS® Association (WRA) calculates an index for the state as a whole and eight districts within the state. While the same caveats apply regarding comparability, Wisconsin with a fourth quarter 1990 index of 154 is an affordable state. (See Table 1). Like many housing markets, stable home prices and declining interest rates have contributed to a rising HAI.

The Florida Association of REALTORS® calculates a housing affordability index for 20 metropolitan areas. The most affordable metropolitan area during fourth quarter 1990 was Pensacola, with an affordability index of 161.6. The least affordable metropolitan area was Naples, with an affordability index of 79.8. The Association is currently developing an index for the whole state.

The CALIFORNIA ASSOCIATION OF REALTORS® (CAR) has developed an affordability index using a different approach from the NAR AI. The CAR uses a "market approach" for developing its HAI, which will be discussed below.

Limitations of NAR-Type Indices

The State Association and Local Board indices are subject to the same limitations as the NAR AIs. The most common criticism relates to the 20 percent downpayment assumption of the AIs for all home buyers combined, and the 10 percent downpayment assumption of the first-time home buyer indices. The *State of the Nation's Housing: 1990* (Joint Center for Housing Studies of Harvard University) reported that 81 percent of renters between the ages of 25 and 34 have insufficient wealth to make a 20 percent downpayment on a starter home; moreover, 70 percent are unable to make even a 10 percent downpayment.

The affordability indices likewise do not address the affordability of operating the home once it has been purchased. This may be an important dimension of home ownership affordability in light of the unprecedented numbers of home owners reverting to renting.[2]

Market Measures of Home Ownership Affordability

The ability of individual prospective home buyers to qualify for mortgages -- measured by NAR-type indices -- forms the basis of the two types of market measures of home ownership affordability. The first type of market measure estimates the *share of households* that can afford a home within a particular market. The second type of market measure estimates the *share of homes* within a market that the typical household can afford.

Share of Households Approach

California Association of REALTORS®. The California Association of REALTORS® Housing Affordability Indices (HAIs) use the share of households approach. Like the measures discussed so far, CAR uses the median-priced home for the state of California as a whole and seven major regions within the state. (See Exhibit 2). The general formula for the HAI is as follows.:

$$\text{CAR HAI} = \frac{\text{Number of Households Which Can Qualify For Mortgage on Home at Median Price or Higher}}{\text{Total Households}}$$

The higher the HAI, the greater the share of households which can qualify for a mortgage on the median-priced (or higher-priced) home, and the more affordable the market.

CAR's indices assume a monthly mortgage payment of not more than 30 percent of monthly household income, in contrast to the 25 percent convention used by the other indices. The mortgage principal and interest payment is based on 30 year mortgage amortized at the Federal Home Loan Bank Board's average interest rate on fixed- and adjustable-rate loans closed on existing homes. Unlike the indices discussed so far, the monthly mortgage payments include property taxes and hazard insurance as well as mortgage principal and interest.

The CAR Housing Affordability Index looks at the qualifying income relative to the distribution of households by income. While the distribution of incomes is also important to the NAR Indices, NAR looks at only one point on the income distribution - the median - to arrive at the NAR AI. In contrast, CAR looks at all incomes at or above the qualifying income. In other words, the share of households with incomes equal to or greater than qualifying income is the CAR HAI.[3]

Affordability generally improved between 1989 and 1990 in California, owing to a reversal in house price rises above income gains. In 1989, only 17 percent of California households could purchase the median-priced home; by 1990, just over one-fifth could. While more households are currently able to afford a home in California than in the past several years, prospective home buyers in California are still at a relative disadvantage. This one-fifth of California households compares to one-half of the households in the United States which could purchase the national median-priced home.

Affordability also improved in five California regions between 1989 and 1990. In Los Angeles, Orange County, San Diego, San Francisco, and Ventura, an additional two to four percent of households can afford to purchase the median-priced house than could in 1989. The share of households that could purchase remained unchanged in Riverside/San Bernardino, and declined from 38 to 31 percent in Sacramento.[4]

Joint Center for Housing Studies of Harvard University. The Joint Center for Housing Studies of Harvard University also estimates the share of households that can afford to purchase a home. In particular, the Joint Center in its *State of the Nation's Housing: 1990* estimated the share of young renting households in the United States that could qualify for financing on a median-priced, starter home. The Joint Center calculates the 1986 share using the most recent year available of the Federal Reserve Survey of Consumer Finances, the dataset used. (Since an estimate is only available for 1986, this measure cannot be used to examine trends in affordability).

Financing costs, terms, and household income assumptions are very similar to those of the indices discussed. (See Exhibit 2). Like the CAR, the Joint Center's mortgage payment includes property taxes and hazard insurance. The largest departure from the other AIs is the Joint Center's house price. While the other indices use prices recorded when the sales contract is signed or when the loan is closed, the Joint Center uses "standardized" home prices. A standardized price is the price of a representative home in a given year, indexed for house price inflation. In this case, the home has the characteristics, e.g., number of rooms, square feet, etc. of the median-valued home purchased by a first-time home buyer aged 25 to 29 in 1977. The index used for adjusting the price is the Census Bureau's C-27 Constant Quality Home Price Index. This price index is designed to hold constant 10 characteristics of new homes sold. These characteristics are floor area, number of stories, number of bathrooms, presence of central air conditioning, type of parking facility, type of foundation, geographic sub-division (12 sub-divisions based on nine Census divisions -- 3 of them divided into 2 parts), location within or outside of metropolitan area, lot size, and the presence of one or more fireplaces.

The Joint Center's mortgage qualification criteria are more comprehensive than the other indices, and more closely reflect those criteria established by the secondary mortgage market. The only mortgage qualification criteria used in the indices discussed so far is that the mortgage payment cannot exceed a certain share of prospective borrower income. The Joint Center also uses this criteria. For a mortgage with a 10 percent downpayment, the required mortgage payment cannot exceed one-quarter of borrower income; for a mortgage with a 20 percent downpayment, the mortgage payment cannot exceed 28 percent of borrower income. In addition, the secondary mortgage market also requires a prospective borrower to have sufficient wealth to meet the downpayment without incurring debt. The Joint Center uses data on household wealth from the Survey of Consumer Finances to determine whether a household meets this criteria, rather than *assume* a prospective borrower has a 10 to 20 percent downpayment as the indices discussed thus far do.

Only small shares of renters can afford a home, according to the Joint Center. Comparison of household wealth and income in 1986 to the upfront cash costs ($15,652) and income needed to qualify for a mortgage ($24,445 minimum assuming a 30 year, fixed-rate mortgage of 9.8 percent with 20 percent downpayment) indicates that only 13.6 percent of the 29 million renting households in the U.S. could purchase a starter home. Of the 11 million renters aged 25 to 34 in 1986, only 12 percent had both the necessary income and wealth. Lowering the downpayment to 10 percent modestly raises the share of young renters who can qualify to 14.5 percent.[5]

The U.S. Bureau of the Census Study. The U.S. Bureau of the Census is currently developing its own estimate of the share of qualified households for the United States and each of the four Census regions. The results of the study are expected to be available in the first-half of 1991. The Census Bureau considers a household's ability to qualify for financing on a median-priced home, a modestly-priced home, and the value of a new home.[6] Like the Joint Center which uses individual household data, the Census Bureau uses data from its 1987 Survey of Income and Program Participation.

The financing costs, terms, and income assumptions are similar to the other measures. (See Exhibit 2). The Census Bureau uses a 28 percent maximum principal, interest, taxes and insurance (PITI)-to-income ratio for conventionally-financed loans. For FHA-insured mortgages, the maximum PITI-to-income is 29 percent.

The Census Bureau study considers other secondary mortgage market criteria as well. Like the Joint Center, the Census Bureau employs household asset and wealth data to determine, rather than assume, the household's ability to meet the required downpayment and closing costs.

The secondary mortgage market also restricts the amount of debt a prospective borrower is allowed to hold. Even if the prospective borrower's required PITI is within the established limits and the borrower has the wealth for the downpayment, a prospective borrower's total debt cannot exceed 8 percent of monthly income in order to qualify for a conventional mortgage. For an FHA-insured mortgage, a borrower's debt cannot exceed 12 percent of income. Unlike the other indices and Joint Center study, the Census Bureau uses household data to determine if a household meets this debt-restriction criteria.

The Census Bureau's study will not investigate the impact of adjustable-rate mortgages (ARMs) on the nation's housing affordability situation. NAR's ARM AIs are always higher than its fixed-rate mortgage indices. This unchanging relationship implies that the median income household has a better chance of qualifying for an ARM than a fixed-rate mortgage. Despite this, preliminary findings suggest that in recent years ARMs have had little impact on increasing the share of households which could afford to purchase a home. ARMs do lower the initial monthly mortgage payment, thereby decreasing the qualifying income needed by prospective borrowers. However, they do little to assist home buyers that do not have the wealth necessary for the downpayment. According to some economists, the wealth requirement is more restrictive than the income requirement. Thus, the preliminary findings of the Census Bureau are hardly surprising.[7]

Share of Homes Approach

Like the other measures discussed in this section, the National Association of Home Builders Relative Affordability Index is a market measure of home ownership affordability. Unlike the others, it is an example of the second type of market measure of home ownership affordability -- the share of homes type.

The National Association of Home Builders (NAHB) Relative Affordability Index (RAI) is the percentage of all new and existing home sales in a market on which the median income household can qualify for a mortgage.

$$\text{NAHB RAI}_{\text{market}} = \frac{\begin{array}{c}\text{New and Existing Home}\\ \text{Sales On Which Median}\\ \text{Income Household Can}\\ \text{Qualify for Mortgage}\end{array}}{\text{Total New and Existing Home Sales}}$$

The higher the RAI, the greater the share of homes on which the median income household can qualify for a mortgage, and the more affordable is the local market. Like many of the indices discussed so far, this qualification depends only on the required mortgage payment not exceeding a certain percentage of the prospective borrower's pretax income.

The maximum-priced home that a household can afford is the basis for the RAI. The RAIs assume that a household can qualify for a mortgage on a home with a price up to 2.6 times its income, based on a 25 percent maximum mortgage payment-to-income and a 30 year, 10 percent fixed-rate mortgage with a 10 percent downpayment.[8]

The distribution of home prices in a housing market is essential to the NAHB RAI. NAHB looks at the share of homes that sold at or below the maximum house price which the median income household can afford. This share of homes determines the affordability of a housing market.[9] (See Exhibit 2).

NAHB calculates the Relative Affordability Index for more than 200 local housing markets. A local market is considered affordable if a median income household can qualify for a mortgage on at least one-half of homes sold during a given period.

Comparing the RAIs across markets indicates the relative affordability of home ownership in different markets during a given time period. For example, in 1990, the least affordable market was Bergen-Passaic, NJ with a 15.4 affordability index. In other words, the median income household in the area could only afford to purchase 15.4 percent of homes sold there during 1990. In sharp contrast, the median income household in Oklahoma City, OK could qualify for financing on 83.9 percent of the homes sold there during 1990.[10]

Comparing the RAIs for a given market across time periods illustrates affordability trends in a given market. In Bergen-Passaic, like most areas in the Northeast, affordability improved between 1989 and 1990. In 1989, only 13.3 percent of homes sold were within reach of the median-income household; in 1990, the median income household could afford 15.4 percent of homes sold. Affordability improved in Oklahoma City as well. While the median income household could afford 81.1 percent of 1989 area home sales, it could afford 83.9 percent in 1990.[11]

The Up-Side and the Down-Side of the Market Measures

The limitations of the market measures of home ownership affordability mirror the limitations of the measures for individual prospective home buyers. This is not surprising given that the ability of individual home buyer families to qualify for mortgages forms the nucleus of market measures. Neither CAR nor NAHB measures the ability of the household to meet the downpayment and closing costs; rather, they assume the prospective home buyer has sufficient resources to make a 10 or 20 percent downpayment. The Joint Center and the Census Bureau studies surmount this shortcoming by using household asset and wealth data to determine whether a household can overcome these upfront obstacles to home ownership.

All of the measures rely on the ability of the household to secure financing similar to that assumed, which is probably not difficult as long as the household is able to make a 10 to 20 percent equity downpayment. Finally, none of the market measures discussed in this section addresses the affordability of operating the home once it has been purchased.[12]

Conclusions

Home ownership is an important source of wealth for most of the nation's households, and an important source of security after retirement. Affordable owner-housing, then, is important to continued wealth accumulation. For owner-housing to remain affordable, incomes must keep pace with housing prices and there must be an adequate supply of mortgage capital available to prospective home buyers. However, for many households, mortgage qualification criteria prevent them from accumulating wealth and saving for the future through home ownership.

An underlying theme of each of the measures discussed in this series is that a household's ability to qualify for a mortgage is nearly synonymous with its ability to afford a house. NAR's *Homebuying and Selling Process: 1989* reports that 93 percent of its survey respondents financed their home purchase, providing validity to this assertion. Many of the affordability measures only consider one qualifying ratio -- that the necessary mortgage payment does not exceed the maximum percentage allowed under secondary mortgage market guidelines.

Mortgage qualification also depends on other criteria. An important criteria not considered by many of the measures is the household's ability to meet the downpayment and closing costs, without incurring debt to do so. The Joint Center and Census Bureau use household wealth data and compare it to the upfront cash costs to determine whether a household can meet the downpayment. Another important criteria not considered by the measures is the maximum total allowable debt. However, the Census Bureau study includes this criteria in its estimation of households which can qualify for mortgages. The restriction on the amount of debt aims to ensure that a household will be able to meet the ongoing costs of home ownership.

Measures of home ownership affordability to individual prospective home buyers are the basis of market measures of home ownership affordability. Any limitations or inadequacies of the individual measures apply to market measures as well. An accurate assessment of the "scope" of a perceived housing affordability problem and the appropriate treatment depends on a proper assessment of affordability to individual prospective home buyers.

Although the measures are different, many of them substantiate the persistence of affordability problems, despite fairly stable home prices, and declining mortgage rates in recent years. The NAR First-Time Home Buyer Affordability Index for the United States stood at 74.2 in 1989, indicating the median income prospective first-time home buyer had less than three-quarters of the income needed to qualify for a mortgage on a starter home. The California Association of REALTORS® Index stood at 20 percent in 1990, indicating that only one-fifth of Californians had the income to qualify for a mortgage on the median-priced, single-family detached home. The Joint Center finds that, in 1986, only 12 to 15 percent of young renting households had the income and wealth to qualify for mortgages. The National Association of Home Builders Relative Affordability Index (overall average for 217 local markets) is 55.5, indicating that the median-income prospective home buyer could qualify for financing on just over one-half of homes sold during 1990.

by
Mary Boehling Schwartz
Housing Economist, Forecasting and Policy Analysis

Endnotes

[1] McIntosh (1990) developed the indices for the Kentucky Association of REALTORS®. The indices are currently available only for the fourth quarter of 1989.

[2] See Fitzroy (forthcoming).

[3] See California Association of REALTORS® (December 1989).

[4] See California Association of REALTORS® (February 1991).

[5] See *The State of the Nation's Housing: 1990*, pp. 15-16.

[6] U.S. Bureau of the Census (1990) defines a "modestly" priced home as the value of a new or existing owner-occupied unit at the upper limit of the first quartile (lower one-quarter) of the cases in each region, from its Survey of Income and Program Participation. It defines the value of a new home as the median value of new single-family home sales for the first and second quarter of 1988, from its Survey of Construction.

[7] See, for example, Linneman and Wachter (1989).

[8] See Megbolugbe (1991).

[9] Unlike many of the affordability measures which use NAR's prices for existing, single-family homes, NAHB's home price data are from Dataman Information Services, which records transactions prices on both new and existing homes. In addition to sales by REALTORS®, Dataman captures sales by other real estate agents, home owners, and others.

[10] See Megbolugbe (1991).

[11] See Megbolugbe (1990 and 1991).

[12] In a separate measure from the one discussed, the Joint Center for Housing Studies of Harvard University (1990) calculates an after-tax cash cost of home ownership. The after-tax cash costs, which include mortgage principal, interest, taxes, hazard insurance, fuel, utilities, and maintenance, provide a rather comprehensive measure of the costs of operating the home once purchased.

References

William C. Apgar, Jr., and Denise DiPasquale, *The State of the Nation's Housing: 1990*, Joint Center for Housing Studies of Harvard University, 1990.

California Association of REALTORS®, "Notes on Housing Affordability Index," December 1989.

__________, "HousingAffordability," *California Real Estate Trends*, Vol. 12, No. 1, January 1991, p. 5.

Fitzroy, Steven, "Reverse Transition Patterns of U.S. Households: An Examination of Recent Shifts from Owning to Renting", *Working Paper* for NATIONAL ASSOCIATION OF REALTORS®, Washington, D.C., forthcoming.

Indiana Association of REALTORS®, "Indiana Housing Affordability Index: First Quarter 1990," prepared by Center for Real Estate Studies, Indiana University, May 1990.

Linneman, Peter F., and Susan B. Wachter, "The Impacts of Borrowing Constraints on Home Ownership," *AREUEA Journal*, Vol. 17, No. 4, Winter 1989, pp. 389-402.

McIntosh, Willard, "The Measurement of Housing Affordability in Kentucky," report prepared by the Center for Real Estate Studies, University of Kentucky, with support of Kentucky Real Estate Commission, Kentucky Association of REALTORS®, and many local Boards of REALTORS® within the state of Kentucky, October 1990.

Megbolugbe, Isaac F., "How Affordable is Your Local Market?," *Housing Economics*, National Association of Home Builders, Vol. XXXIX, No. 1, January 1991, pp. 13-15.

__________, "How Affordable is Your Local Market?," *Housing Economics*, National Association of Home Builders, Vol. XXXVIII, No. 1, January 1990, pp. 19-21.

New York State Association of REALTORS®, "Affordability Index," *The New York State Housing Trends*, Vol. 6, No. 4, Fourth Quarter 1990, p. 11.

U.S. Bureau of the Census, Housing and Household Economic Statistics Division, "Who Can Afford to Buy a Home?: Methodology," unpublished methodology, October 17, 1990.

Wisconsin REALTORS® Association, "Housing Affordability," *Wisconsin Housing Trends*, March 1991, p. 3.

EXHIBIT 1
INDIVIDUAL HOMEOWNERSHIP AFFORDABILITY INDICES

Index (Coverage)	Objective*	Home Price	Mortgage Rate**	Mortgage Term	Down Payment	Income	Ratio of Mortgage Payment*** to Income	Years Available
Kentucky Association of REALTORS • Composite Affordability (Kentucky; six regions; select areas within each region)	Can family with median income qualify for financing on median-priced home?	Median-priced, existing single-family home from 19 MLS in Kentucky	Average interest rate on FRMs and ARMs on loans closed on existing homes; current, effective rate; from Federal Home Loan Bank Board	30 yrs.	20%	Median family income, from HUD	Cannot exceed 25%	Fourth quarter 1989; monthly Oct.-Dec. 1989******
Kentucky Association of REALTORS • First-time Homebuyer Affordability (Same as above)	Can potential first-time home buyer family with median income qualify for financing on median-priced starter home?	85% of above	Above rate plus 0.25% for private mortgage insurance (PMI)	30 yrs.	10%	Median income of renting families, ages mid-20s to mid-40s; from HUD's Office of Economic Affairs	Same as above	Same as above
New York State Association of REALTORS • Fixed Rate Mortgage Affordability (New York State)	Can family with median income qualify for financing on median-priced home?	Median-priced, existing, single-family home; from over 40 local boards of REALTORS® in NY	Current, effective mortgage on FRMS; from HSH Associates****	30 yrs.	20%	Median family income; from CACI*****	Cannot exceed 25% (pmt does not include property taxes and insurance)	Quarterly 1980 forward

* A household's ability to qualify depends only on the required mortgage payment not exceeding the percentages of income in column 8.

** Effective rate includes amortized fees and loan points.

*** Mortgage principal and interest payment is calculated from home price, mortgage rate, term and loan-to-value (LTV). Neither the Kentucky nor the New York State Association of REALTORS® includes property taxes and hazard insurance in the mortgage payment.

**** HSH Associates is a private consulting firm which surveys some 2,000 mortgage lenders each week.

***** CACI is an international professional and high technology services organization, whose services include provision of demographic information for U.S. households.

****** Not currently published as an ongoing series like the NAR AIs.

EXHIBIT 2
MARKET MEASURES

Index/ Measure (Coverage)	Objective**	Home Price	Mortgage Rate***	Mortgage Term	Down Payment	Income	Ratio of Mortgage Payment-***** to Income	Years Available
CAR Housing Affordability Index (California; 7 major regions)	What share of households can qualify for financing on the median-priced home?	Median-priced, existing, single-family home; from 74 Boards of REALTORS® and Multiple Listing Services	Average interest rate on FRMs and ARMs on loans closed on existing homes; current, effective rate; from the Federal Home Loan Bank Board.	30 yrs.	20%	Distribution of households by income; since 1988, from National Planning Data Corporation****	Cannot exceed 30%	California Annually 1979 forward; monthly 1986 forward; Regional Annually 1984 forward; monthly 1986 forward
Joint Center for Housing Studies of Harvard University Study* (U.S.)	What share of renting households (and young renting households) can qualify for financing on the starter home?	Median value of house purchased by first-time homebuyer aged 25 to 29 in 1977, from American Housing Survey indexed by C-27 Constant Quality Home Price Index; from Bureau of Census' Construction Reports	Nominal rate on fixed-rate mortgages (amortized loan fees and points are not included); from Federal Home Loan Bank Board	30 yrs.	20%	Income for each housheold in Survey of Consumer Finances	Cannot exceed 28 (25) percent for 80% (90%) LTV	1986 only
U.S. Bureau of the Census Study* (U.S., 4 Census regions)	What share of renting households can qualify for financing on a starter home?	Median-priced home, from SIPP; Modestly-priced home, from SIPP; value of new home, from Census' Survey of Construction	Conventional loans, contract interest rate on loans closed; from Federal Home Finance Board's Monthly Interest Rate survey; FHA-insured loans, interest rates on loans closed with FHA insurance, from Federal Housing Administration	30 yrs.	Min. 5% for both conventional and FHA-loans	Income for each household in SIPP	Convention loans, cannot exceed 28%;- FHA-insured loans, cannot exceed 29 %	1987 only; Forthcoming study
NAHB(over 200 metropolitan areas)	On what share of homes sold could a median-income family have qualified for financing?	Existing and new, single-family homes; data from Dataman Information Services	Nominal rate on fixed-rate mortgages (amortized loan fees and points are not included); typical prevailing rate assumed	30 yrs.	10%	Median family income; from U.S. Department of Housing and Urban Development	Cannot exceed 25%	Annually and quarterly 1990 forward

* These are not technically indices but one-time measures. The household data for the studies are the Federal Reserve's 1986 Survey of Consumer Finances (Joint Center's) and the U.S. Bureau of the Census' Survey of Income and Program Participation (SIPP), 1987 Panel, Wave 4 (Census Bureau).

** **For the CAR and NAHB indices, a household's ability to qualify for a mortgage depends only the required mortgage payment not exceeding the percentages of income in column 8. The Joint Center and the Census Bureau use more extensive qualification criteria, which more accurately represents secondary mortgage market requirements.**

*** **Effective rate includes amortized fees and loan points.**

**** **National Planning Data Corporation is a private company specializing in demographic research.**

***** **Mortgage principal and interest payment is calculated from home price, mortgage rate, term and loan-to-value (LTV). Each market measure, except for NAHB, includes**

U.S. Economic Outlook: April 1991

Quarterly figures are seasonally adjusted annual rates

	90.3	90.4	91.1	91.2	91.3	91.4	92.1	92.2	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	1.4	-1.6	-2.7	0.3	3.0	2.9	2.9	3.2	2.5	1.0	-0.2	2.9	2.8
Industrial Production	4.0	-7.2	-9.1	-4.4	1.8	3.7	3.1	3.4	2.6	1.0	-3.4	3.1	5.0
Civilian Employment	-1.3	-0.9	-2.6	-1.2	0.8	0.9	1.1	1.5	2.0	0.5	-1.0	1.1	1.4
GNP Inflation Index	3.7	2.8	3.8	2.7	3.2	2.8	3.4	3.0	4.1	4.1	3.3	3.1	3.1
Consumer Prices	6.9	7.0	3.7	2.2	3.8	[illegible]	3.3	3.3	4.8	5.4	4.4	3.4	3.5
Value of the U.S. Dollar	-20.7	-19.0	7.6	26.2	2.5	[illegible]	3.7	3.4	6.2	-9.6	-0.3	4.6	2.4
Percent													
Mfg. Capacity Utilization	82.9	80.8	78.2	77.2	77.3	77.7	78.0	78.4	83.9	82.3	77.6	79.0	82.0
Civilian Unemployment	5.6	5.9	6.5	6.9	6.8	6.8	6.7	6.5	5.3	5.5	6.8	6.4	5.9
Percent of GNP													
Federal Tax Receipts	20.4	20.4	20.5	20.4	20.5	20.6	20.7	20.7	20.2	20.3	20.5	20.7	20.7
Federal Expenditures	23.1	23.7	21.6	24.7	24.4	24.1	24.3	24.1	22.8	23.3	23.7	24.0	23.3
Federal Budget Deficit	-2.6	-3.3	-1.0	-4.2	-3.9	-3.6	-3.6	-3.3	-2.8	-3.0	-3.2	-3.2	-2.6
Interest Rates, Percent													
Federal Funds Rate	8.2	7.7	6.4	6.1	6.0	6.1	6.2	6.3	9.2	8.1	6.2	6.2	6.3
3-Month T-Bill Rate	7.5	7.0	6.0	6.0	5.8	5.8	5.8	5.8	8.1	7.5	5.9	5.8	5.8
Prime Rate	10.0	10.0	9.2	8.9	8.8	8.5	8.6	8.5	10.9	10.0	8.8	8.5	8.4
Discount Rate	7.0	6.9	6.2	5.9	5.8	5.8	5.7	5.7	6.9	7.0	5.9	5.7	5.7
Corporate AAA Bond Yield	9.4	9.3	8.9	8.9	8.7	8.6	8.5	8.4	9.3	9.3	8.8	8.4	8.1
30-Year Government Bond Yield	8.8	8.5	8.2	8.1	8.0	8.0	7.9	7.9	8.4	8.6	8.1	7.8	7.6
Mortgage Rates, Percent													
30-Year Fixed Rate	10.1	10.0	9.5	9.3	9.1	9.0	8.9	8.9	10.3	10.1	9.2	8.9	8.8
1-Year Adjustable	8.4	8.1	7.8	7.5	7.4	7.4	7.4	7.5	9.3	8.4	7.5	7.5	7.5
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	4,127	3,879	3,764	3,918	4,143	4,268	4,424	4,473	4,442	4,179	4,023	4,501	4,666
Existing Single-Family Sales	3,297	3,117	3,062	3,135	3,270	3,384	3,492	3,524	3,467	3,305	3,213	3,546	3,676
New Single-Family Sales	523	468	454	502	529	565	580	599	654	532	513	601	637
Housing Starts	1,131	1,042	933	1,021	1,128	1,140	1,213	1,254	1,381	1,203	1,055	1,266	1,344
Single-Family Units	856	786	724	808	900	911	960	978	1,005	901	836	985	1,020
Multi-Family Units	274	256	209	213	228	229	253	277	376	302	220	281	323
2-4 Family Units	32	31	25	26	28	28	31	33	56	37	27	34	39
5+ Family Units	242	225	184	187	201	201	222	243	320	264	193	247	284
Mobile Homes Shipped	188	178	185	205	231	236	241	244	199	188	214	245	244
Percent change -- Year Ago													
Total Single-Family Sales	-6.5	-13.8	-15.9	-7.4	0.4	10.0	17.5	14.1	-4.4	-5.9	-3.7	11.9	3.7
Existing Single-Family Sales	-4.3	-11.9	-11.1	-6.8	-0.8	8.6	14.1	12.4	-3.6	-4.7	-2.8	10.4	3.7
New Single-Family Sales	-25.2	-28.2	-23.9	-6.9	1.2	20.7	27.7	19.3	-3.3	-18.6	-3.6	17.3	6.0
Housing Starts	-16.1	-22.9	-34.9	-15.2	-0.2	9.4	30.1	22.9	-7.2	-12.9	-12.2	19.9	6.1
Single-Family Units	-14.6	-20.9	-32.0	-9.8	5.1	15.8	32.7	21.0	-7.2	-10.4	-7.2	17.8	3.6
Multi-Family Units	-20.6	-28.4	-43.4	-30.8	-16.7	-10.5	21.0	29.9	-7.2	-19.7	-27.1	28.0	14.8
2-4 Family Units	-43.2	-42.2	-41.2	-40.5	-13.6	-10.5	21.0	29.9	-5.1	-32.8	-28.7	28.0	14.8
5+ Family Units	-16.2	-26.0	-43.7	-29.3	-17.1	-10.5	21.0	29.9	-7.6	-17.4	-26.9	28.0	14.8
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	96.6	92.2	95.3	95.8	96.5	97.8	99.8	101.3	92.9	95.2	96.3	101.9	106.9
New Home Prices	116.7	122.0	124.5	125.3	126.4	128.6	130.5	132.4	120.4	122.3	126.2	133.1	139.8
Percent Change - Year Ago													
Existing Home Prices	1.7	-0.5	-0.2	-0.8	-0.1	6.1	4.8	5.7	4.2	2.4	1.2	5.7	5.0
New Home Prices	-2.5	-2.0	0.6	-1.1	8.3	5.4	4.9	5.7	6.2	1.6	3.2	5.5	5.0

Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy. Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

- A7000-1

REAL ESTATE OUTLOOK

Vol. 4, No. 5

May 1991

A Monthly Forecast for the Economy and Real Estate

FORECAST SUMMARY

- While attention remains fixed on the departing recession, the recovery is expected to steal upon the stage quietly and will take some time to be recognized. After months of deteriorating conditions, the economy fell into the recession with a bang. Several factors, namely war preparations, the federal budget deal, soaring gas prices, and a resulting decline in consumer confidence, trumpeted the onset of the recession.

- In the meantime, signs of recovery will be countered by signs of continued decline. For example, the unemployment rate fell 0.2 percentage points in April, but at the same time, payroll employment declined. Sales of both new and existing homes have moved up in the past two months, but auto sales dropped another notch. All of this amounts to a standstill in in economic growth in the second quarter, according to the NAR forecast.

- After February's impressive performance, housing starts retreated in March, dropping 9.3 percent to an annual rate of 901,000 units. Weakness occurred in the construction of both single and multifamily structures. While the March figures are disheartening, they remain above January's low figures, and support the view that January's dismal performance was the nation's low point.

- Meanwhile, both new and existing home sales held steady in March, after increasing in February. A few key factors appear to be contributing to this renewed activity, notably lower mortgage rates and growing consumer confidence in the economy. Buoyed by robust activity in the West, new home sales increased one percent in March to an annual rate of 490,000 units. After increasing 9 percent in February, sales of existing single-family homes increased 0.6 percent in March, to an annual rate of 3.18 million units.

- Median home prices for both new and existing single-family homes increased in March. The median price of an existing single-family home increased to $96,500, 2.7 percent above February's median price of $94,000. In the market for new single-family homes, the median price increased 4.2 percent, to $125,000 in March. Modest appreciation is expected this year, with the median price of an existing single-family home projected to increase by 1.9 percent, and 3.4 percent for a new single-family home.

IN THIS ISSUE

NATIONAL ASSOCIATION OF REALTORS®
REALTOR®
The Voice for Real Estate™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS ®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991 NATIONAL ASSOCIATION OF REALTORS®

The Clan of the Cave Economist, or Dem Bones, Dem Bones, Dem Dry Bones

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

Deep in the Rift Valley of East Africa, the cradle of humanity, a team of eminent paleontologists have made a discovery that is likely to add significantly to our understanding of how mankind evolved. Following the chance discovery of a cave mouth by a local herdsman, the scientists have uncovered an ancient burial site of *homo economicus,* an obscure and little understood branch of early man, that functioned side by side with *homo sapiens*. In fact, the burial site contained three of the multitude of subspecies that characterize the species. All appeared to have been put to death in particularly grisly fashion.

But perhaps of greatest significance was the discovery of tablets containing in crude pictographs the circumstances of the execution of the *economici*. Here, scientists hope, can be found the reasons why our ancestors had such a difficult time dealing with them.

We know from earlier finds that *homo economicus* served a peculiar function in the primitive clan. Essentially, the members of the clan relied on him for a mixture of present description and soothsaying. Unfortunately, these records indicate, *homo economicus* was terrible at the latter, yet continued to receive the respect of the clan. Scientists have found this aspect of early society particularly confusing, especially in light of the fact that other useless clan members were quickly eliminated.

The tablets discovered at the grave tell a tale of a clan council convened to deal with an important problem. It seems that after eight solid years of great hunting, good crops and a general increase in the well-being of the clan, things had changed. Now, fewer of the clan went out to hunt, the results were meager, and agriculture waned. And, to its great humiliation, the clan had to rely on the support of other clans to maintain its prosperity. Now, they had come together to ask their advisors why this had come to pass and what would happen next.

The first to speak was *homo economicus pollyanacus*. This subspecies lived with the chief of the clan, and served the needs of the chief to have a positive slant on his actions. In other burial sites, *pollyanacus* remains were often found with small mastodon statues and short clubs tipped with flat pieces of iron. *Pollyanacus* maintained that the current lull in hunting results was temporary and would end in the next day or two. Because the clan leaders, in their wisdom, took less and less of the daily kill, the last eight years had placed the clan in an ideal position to prosper forever. Soon, more and more of the clan would go out to hunt and gather and the good days would come back. The people heard this and were glad. They spoke of feeling better and resolved to hunt more and make the earth produce its bounty.

Next to speak was *homo economicus pessimisticus*, the largest of the subspecies. This group tended to grow facial hair as a regular practice and specialize in the training of the clan's youth. Rarely part of the main ruling elite of the clan, *pessimisticus* instead hung at the fringes of the clan, associating primarily with the grumblers and those who carried news from clan to clan.

According to the tablets, *pessimisticus* spoke at nearly interminable length about all the things that were wrong with the clan. The prosperity of the past eight years had been an illusion bought at the price of the clan's future. Present consumption had been increased only because the clan was willing to sell its resources and assets to other clans.

Now, the people did not hunt because those other clans owned all the hunting grounds. This was no temporary lull, but a longer term fault in the clan itself. The people heard this and were afraid. They remembered the time many years ago when a clan leader from a Southern family said the same things and they came true.

Finally, *homo economicus monetarycus* arose. These were the most respected of the *economici*. They lived in the holy place and took counsel with none of their brethren. Rather, they passed the wisdom down one to another and through their incantations made the people of the clan act in certain ways. There is a problem, *monetarycus* said, because the people don't have sufficient reason to hunt or till. They fear the future and feel guilty about their actions in the past.

The leaders of the tribe urged *monetarycus* to utter the spell that would get the people to hunt and farm again, but he hesitated, arguing that too powerful a spell could cause a reaction that would require that two hunters, not one, were necessary to provide an antelope. This had nearly killed the clan in the past.

At this point, the tablets have some significant gaps. But, when the narrative resumes, *monetarycus* has been persuaded to utter the sacred words and some of the clan responds, not by hunting more, but by creating new caves. This helps, and eventually the clan becomes more active, although it never quite reaches the glories of the past period.

The tablets also reveal that the quarrels among the *economici* continued in later clan gatherings until the people and the leaders got so confused, frustrated and upset, that the chief ordered the execution of them all.

Further analysis of the tablets found at the gravesite has convinced the paleontologists that this episode represented the last vestige of *homo economicus* in the history of humanity. Paleontology is still far from an exact science.

Outlook for the Economy and Real Estate

After months of deteriorating conditions, the economy fell into the recession with a bang. There was the drama of war preparations, the federal budget deal, the soaring gas prices -- it's no wonder consumer confidence plummeted so fast. While none of these were prime causes of the recession, they did trumpet its onset. Now, as we wait for the next turning point, the headlines are unlikely to herald the return of growth. Instead, the recovery will steal upon the stage quietly, while attention remains fixed on the cacophony of the departing recession. And as the various sectors of the economy respond to improved economic health, the upswing will take some time to be recognized.

In the meantime, the signs of recovery will be countered by signs of continued decline. For example, the unemployment rate fell 0.2 percentage points in April, but at the same time payroll employment declined. Sales of both new and existing homes have moved up in the past two months, but auto sales dropped another notch. All of this amounts to a standstill in economic growth in the second quarter, according to the NAR forecast. Output is anticipated to drop at a miniscule 0.2 percent annual rate, and the recovery is expected to take hold during the third quarter. A 2.4 percent annual growth rate is projected in the second half of 1991; the economy is then expected to post a solid 2.8 percent growth rate in 1992.

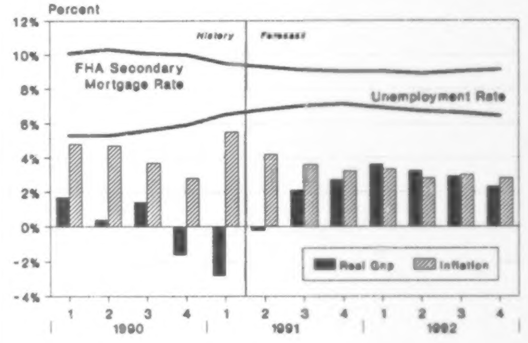
Domestic Spenders Sapped

Underscoring the point that the Persian Gulf crisis was not the primary cause of the expansion's end is the official designation of July 1990 as the month the recession began. While the Iraqi invasion in August and the run-up in oil prices (which began in late July) may have turned a brief downturn into a deeper recession, the U.S. expansion was already winded by July. It lasted a marathon 92 months and was second only to the 106-month expansion of the 1960s, which was fueled in part by war expenditures.

Consumers, businesses, and governments appear to be retrenching in the early 1990s. Growth in the demand for goods and services from these three sectors -- known as domestic demand -- wound down in the late 1980s, as the chart at right shows. In 1991, growth in domestic demand is likely to turn negative. Hampered by the S&L bailout, higher oil prices, higher taxes, and preparations for war, the economy in 1990 didn't have enough muscle to reverse such a fundamental trend. What caused domestic demand growth to slide? One leading suspect is the Federal Reserve's inflation-fighting "soft landing" policy that sent short-term interest rates up in the late 1980s; another prime suspect is the increasing debt leverage ratios of the 1980s, which left all three sectors short of breath.

As domestic demand waned in recent years, continued growth in the economy became increasingly reliant on foreign demand. Rising exports played an important role in continuing the expansion at several key points and are expected to contribute significantly in the coming recovery. But the growing prospect of recession in Germany and Japan, joining slumps already underway in the United Kingdom, Austraila and Canada, poses an important risk for the expected recovery. Also threatening foreign demand is the dollar's recent resurgence. The rise of the

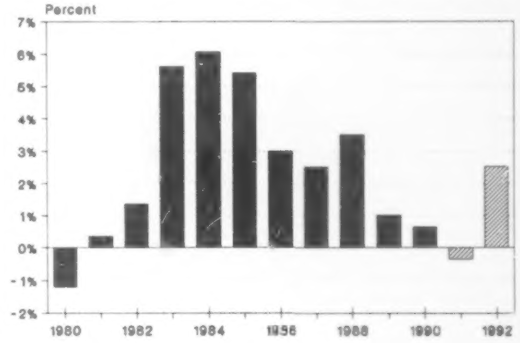
The Economic Outlook



Sources: Bureau of Economic Analysis; NAR forecast

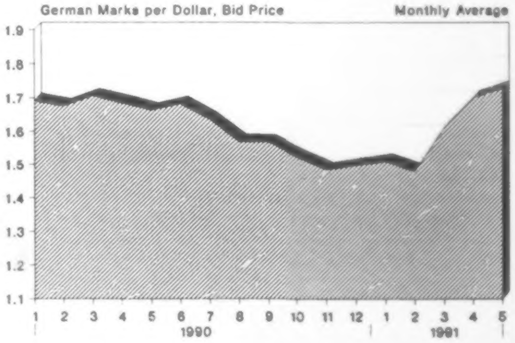
Domestic Demand Cools Off

Consumer Spending, Investment, & Government Outlays



Source: Bureau of Economic Analysis

Dollar Surges Against the Deutschmark



Source: Generale de Banque, New York, via Haver Analytics dollar -- it's moved up 15 percent against the German Deutschmark since the year began -- effectively lowers the cost to U.S. consumers of imported goods but also raises the price of American goods overseas.

Growth To Remain Below Par For Fifth Consecutive Year

This downturn is nearing the 11-month length of the average recession, but it is still substantially shallower. The drop in output in the eight previous postwar recessions averages 2.6 percent; the current recession is expected to see a drop of 1.2 percent. Of greater concern, however, is the extended period of slow growth, seen in the chart at right. Since early 1988, the U.S. economy has not had even one quarter of growth that exceeded the average growth rate achieved during the 1983-89 period. A subdued recovery will continue this period of restrained growth through 1992. Five years of mediocre performance is a weak foundation for growth in jobs, personal income, and housing, among other areas of the economy.

Unemployment Rate Drops to 6.6 Percent

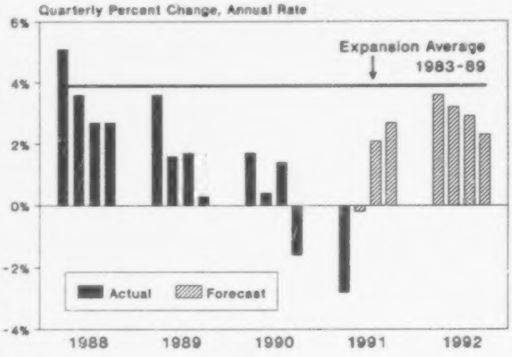
Employment figures released in early May contained a surprising fall in the unemployment rate to 6.6 percent from 6.8 percent. Many analysts had expected to see the rate rise to 7.0 percent, but increases in government hiring and self-employment apparently turned the rate down. Among payroll employees, another 125,000 workers lost their jobs in April, but the decline was only half of the average loss seen in the first three months of 1991.

Since it generally continues to fall for a few months after the economy begins to turn up, employment is a lagging indicator of the economy's health. Before hiring more workers, businesses generally increase output by lengthening the workweek and asking current workers to put in more overtime. In April, both the manufacturing workweek and factory overtime rose by 0.1 hour. Since these measures directly tell of activity on the factory shop floor, they're more robust indicators of current economic conditions than changes in consumer confidence and the stock market. Because of their psychological content, these two latter measures have more value in projecting the direction of the economy over the next several months than in assessing current conditions.

Why The Fed Isn't Too Quick to Ease

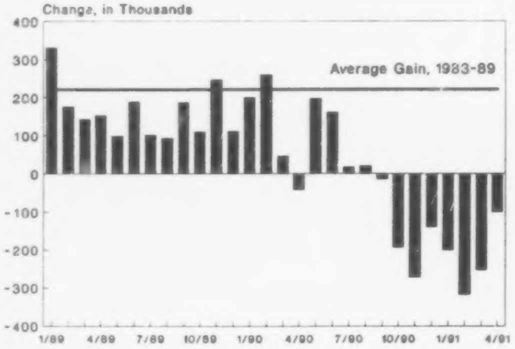
While the recession is taking its toll on employment, it's also taming inflation, which is expected to fade a bit over the next couple of years. After accelerating in each of the past four years, growth in the Consumer Price Index is expected to ease to 4.7 percent in 1991 from its 5.4 percent clip in 1990. Two years of 3.5 percent gains are anticipated in 1992 and 1993. This is not the price stability that the Federal Reserve is seeking, and it's one reason the Fed is currently hesitant to ease credit any further. In judging the balance between ease and restraint, the monetary authorities are well aware that the effects of changes in monetary policy take time to work their way through the economy. Adding extra credit now, before earlier changes in policy have had a chance to work, may not aid the recovery while risking higher inflation later.

Real GNP's Sub-Par Performance
Four Years and Counting



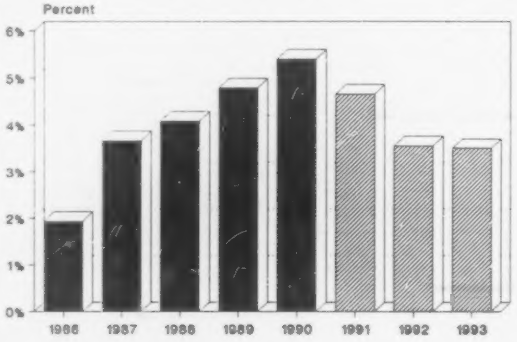
Source: Bureau of Economic Analysis; NAR forecast

Payrolls Cut Again in April
Private Nonfarm Employment



Source: Bureau of Labor Statistics

Milder Inflation Expected in 1991-93
Consumer Price Index



Source: Bureau of Labor Statistics; NAR forecast

Housing Starts

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

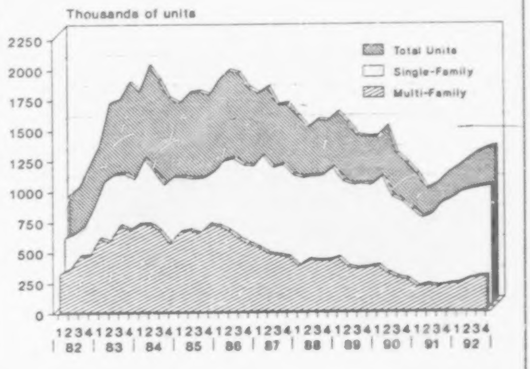
	Total	SF	2-4	5+
Mar 1990	1,298	988	35	275
Nov 1990	1,130	769	54	307
Dec 1990	971	751	17	203
Jan 1991	847	648	29	170
Feb 1991	993	778	42	173
Mar 1991	***901***	***732***	***28***	***141***
Annual Averages:				
1989	1,381	1,005	56	320
1990	1,203	901	37	265
Percent Changes in March 1991 since:				
Mar 1990	-30.6	-25.9	-20.0	-48.7
Feb 1991	-9.3	-5.9	-33.3	-18.5

Regional Data

	Northeast	Midwest	South	West
Mar 1990	138	276	520	364
Nov 1990	147	232	483	268
Dec 1990	110	233	395	233
Jan 1991	86	167	361	233
Feb 1991	90	303	388	212
Mar 1991	***97***	***223***	***393***	***188***
Annual Averages:				
1989	181	269	535	397
1990	135	259	478	330
Percent Changes in March 1991 since:				
Mar 1990	-29.7	-19.2	-24.4	-48.4
Feb 1991	7.8	-26.4	1.3	-11.3

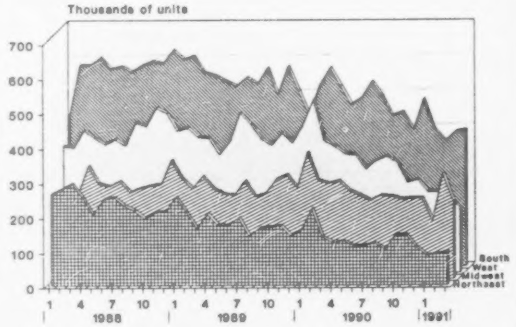
Source: Bureau of the Census, Construction Reports, Series C25

Housing Starts



Source: Bureau of the Census; Real Estate Outlook forecast

Housing Starts by Region



Source: Bureau of the Census

After February's impressive performance, housing starts retreated in March, dropping 9.3 percent to an annual rate of 901,000 units. Weakness occurred in the construction of both single and multifamily structures. Starts of single-family homes fell 5.9 percent, to 732,000 units, while starts for multifamily homes fell 21.4 percent, to 169,000 units. While the March figures are disheartening, they remain above January's low figures.

March's decline was concentrated in two regions of the country. The Midwest, which led February's rally, accounted for most of the decline, decreasing 26.4 percent to an annual rate of 223,000 units. Weakness in the West also contributed to the decline, where starts fell 11.3 percent to 188,000 units. On a brighter note, the Northeast showed signs of stabilization, posting a 7.8 percent increase to 97,000 units. The South saw little change in activity from February to March, increasing a modest 1.3 percent, to 393,000 units.

Starts are expected to stabilize and regain strength in the months ahead. Single-family starts are projected to increase from an annual rate of 719,000 units in the first quarter of 1991 to 879,000 units by the end of the year. In the multifamily market, a tight lending environment will continue to limit construction activity in 1991. Starts will regain strength in the first half of 1992, and will increase at a healthy 26.4 percent in 1992. Single-family starts are projected to increase by 20.4 percent in 1992. Total housing starts are forecast to grow by 21.8 percent in 1992.

New Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

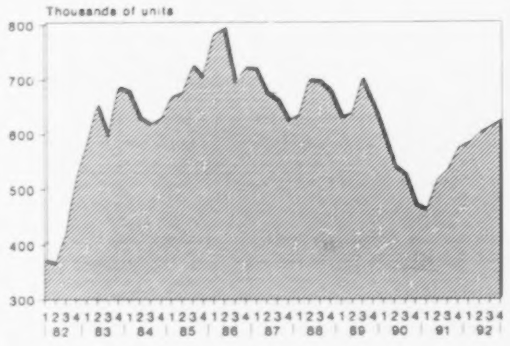
		Mo. Ago % Chg.	Yr. Ago % Chg.
Mar 1990	559	-7.8	0.5
Apr 1990	534	-4.5	-12.5
May 1990	535	0.2	-17.8
Jun 1990	549	2.6	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	409	-11.9	-34.8
Feb 1991	485	18.6	-20.0
Mar 1991	***490***	***1.0***	***-12.3***
Annual Averages:			
1989	654		-3.1
1990	532		-18.5

Regional Data

	Northeast	Midwest	South	West
Mar 1990	84	94	221	160
Sep 1990	61	93	215	134
Oct 1990	74	70	209	113
Nov 1990	68	86	205	122
Dec 1990	62	86	195	121
Jan 1991	48	64	182	115
Feb 1991	53	106	199	127
Mar 1991	***47***	***90***	***197***	***155***
Annual Averages:				
1989	90	103	258	202
1990	74	90	223	146
Percent Changes in March 1991 since:				
Mar 1990	-44.0	-4.3	-10.9	-3.1
Feb 1991	-11.3	-15.1	-1.0	22.0

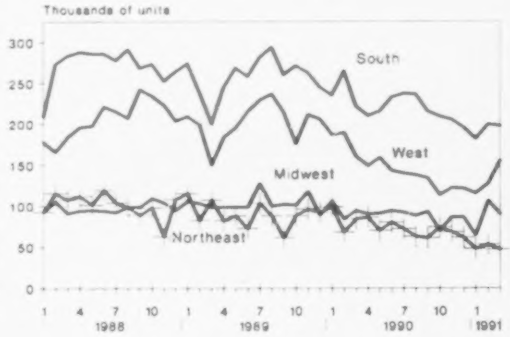
Source: Bureau of the Census, Construction Reports, Series C25

New Home Sales



Source: Bureau of the Census; Real Estate Outlook forecast

New Home Sales by Region



Source: Bureau of the Census

Buoyed by vigorous activity in the Western region, new home sales rose for the second consecutive month this year. Total sales increased a modest one percent in March to an annual rate of 490,000 units. Following a large increase of 18.6 percent in February, March's sales increase is a sign of stability. The March figures support the view that January's dismal performance will be the nation's low point. A few key factors appear to be contributing to this recovery, notably lower mortgage rates and growing consumer confidence in the economy.

The West was the only region to record an increase in March, where sales grew by 22 percent to 155,000 units. After a spectacular gain of nearly 66 percent in February, sales in the Midwest declined by 15.1 percent to 90,000 units. Sales in the South fell by one percent, to 197,000 units. Still suffering from the effects of overexpansion in the real estate market, the Northeast saw sales decline by 11.3 percent to 47,000 units.

A recovery in the housing market is reflected in the forecast for new home sales. Favorable financing conditions, growing consumer confidence and pent-up demand will positively impact sales volume during the forecast period. New home sales are expected to rally as early as the second quarter of 1991, increasing 11.9 percent to an annual rate of 516,000 units. Sales are expected to grow at a healthy clip in 1991, increasing 3.5 percent and 7.3 percent in the third and fourth quarters of 1991, respectively. In 1992, sales will increase 15.9 to 604,000 units.

Existing Single-Family Home Sales

(Seasonally Adjusted Annual Rates, in Thousands)

National Data

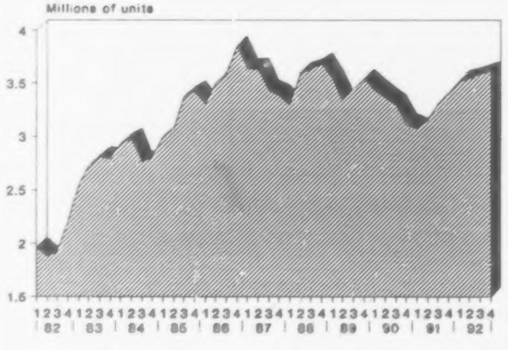
		Mo. Ago % Chg.	Yr. Ago % Chg.
Mar 1990	3,440	0.6	0.3
Apr 1990	3,370	-2.0	-2.0
May 1990	3,350	-0.6	3.1
Jun 1990	3,370	0.6	1.2
Jul 1990	3,320	-1.5	-1.8
Aug 1990	3,410	2.7	-0.9
Sep 1990	3,160	-7.3	-10.0
Oct 1990	3,070	-2.8	-12.0
Nov 1990	3,150	2.6	-11.5
Dec 1990	3,130	-0.6	-12.1
Jan 1991	2,900	-7.3	-16.4
Feb 1991	3,160	9.0	-7.6
Mar 1991	***3,180***	***0.6***	***-7.6***
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

Regional Data

	Northeast	Midwest	South	West
Mar 1990	510	960	1,360	600
Oct 1990	500	820	1,240	500
Nov 1990	500	860	1,280	500
Dec 1990	500	880	1,260	490
Jan 1991	460	810	1,180	450
Feb 1991	500	880	1,240	540
Mar 1991	***520***	***970***	***1,150***	***530***
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in March 1991 since:				
Mar 1990	2.0	1.0	-15.4	-11.7
Feb 1991	4.0	10.2	-7.3	-1.9

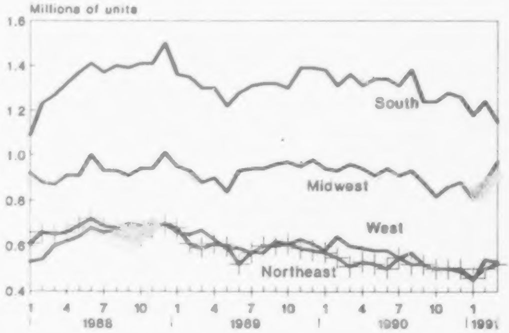
Source: National Association of Realtors,® "Home Sales"

Existing Home Sales



Source: NAR Economics & Research; Real Estate Outlook forecast

Existing Home Sales by Region



Source: NAR Economics & Research

After increasing 9 percent in February, sales of existing homes remained steady in March, increasing 0.6 percent to an annual rate of 3.18 million units. Activity in the lower price ranges dominated many markets, as favorable mortgage rates continued to draw buyers into the market and made homeownership more affordable to those with modest incomes.

By region, the Midwest and the Northeast recorded increases in sales, while the South and the West experienced declines. The Midwest, with its ample supply of moderately priced homes, had the largest gain, increasing 10.2 percent to 970,000 units. Sales rose for the second consecutive month in the Northeast, reaching 520,000 units, 4 percent above February's rate of 500,000 units. In the South, sales fell 7.3 percent to 1.15 million units. The West posted a resale rate of 530,000 units, down 1.9 percent from February's rate of 540,000 units.

As early as the the second quarter of 1991, sales are expected to rise, increasing 2.1 percent to 3.15 million units. By mid-summer, the full impact of favorable mortgage rates should be reflected in a noticeably larger volume of purchases. According to the NAR forecast, third quarter sales are projected to increase by 5 percent to an annual rate of 3.30 million units. Between the first and fourth quarters of 1991, sales are expected to increase by 331,000 units. The market will then be positioned for robust growth in 1992, when sales are expected to increase by 10.2 percent, to 3.56 million units.

Single-Family Home Prices

(In Dollars)

National Data

	Median		Average	
	Existing	New	Existing	New
Mar 1990	96,100	119,400	119,200	144,600
Oct 1990	92,900	120,000	115,900	153,000
Nov 1990	92,000	118,900	115,600	144,800
Dec 1990	91,700	127,000	114,100	153,400
Jan 1991	95,600	120,000	123,000	150,700
Feb 1991	94,000	120,000	119,700	150,500
Mar 1991	***96,500***	***125,000***	***122,500***	***163,400***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in March 1991 since:				
Mar 1990	0.4	4.7	2.8	13.0
Feb 1991	2.7	4.2	2.3	8.6

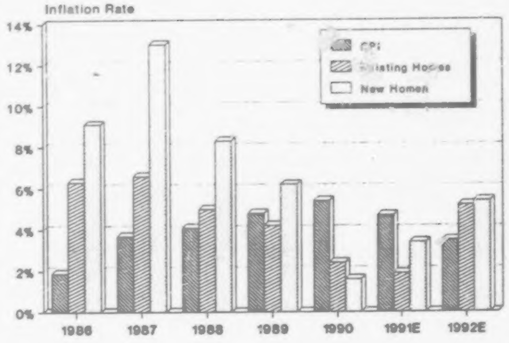
Regional Data

Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Mar 1990	147,900	73,500	85,800	140,500
Oct 1990	136,200	72,000	83,200	142,000
Nov 1990	134,200	71,800	83,500	139,600
Dec 1990	134,400	72,300	82,800	131,400
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	***142,300***	***76,200***	***87,500***	***137,600***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in March 1991 since:				
Mar 1990	-3.8	3.7	2.0	-2.1
Feb 1991	3.7	-0.3	5.2	0.4

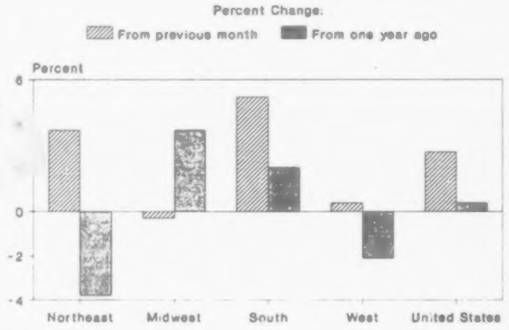
Source: National Association of Realtors,® "Home Sales"

Home Prices



Source: Bureau of the Census; E Real Estate Outlook forecast

Home Prices by Region



Source: NAR Economics & Research

The national median existing single-family home price increased to $96,500, 2.7 percent above February's median price of $94,000, and 0.4 percent above the median price recorded one year ago. In the market for new single-family homes, the median price increased 4.2 percent to $125,000 in March. Relative to one year ago, the median price of a new single-family home appreciated 4.7 percent.

The average price of an existing single-family home increased by 2.3 percent in March to $122,500. Since March of 1990, the average price has risen 2.8 percent. The average price of a new single-family home increased to $163,400 in March, 8.6 percent above February's median price of $150,500.

Modest appreciation in the median price of existing single-family homes is expected over the next year, with an overall increase of 1.9 percent in 1991. Prices will begin to firm at the beginning of 1992, and are projected to increase 5.2 percent in that year. New single-family home prices should experience strong appreciation in 1991, with prices projected to increase by 3.4 percent. In 1992 the median price of a new single-family home is projected to increase by 5.4 percent.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

The Payoffs and Risks of Easing Monetary Policy:

Results of a Model-Based Simulation

The Federal Reserve has come under pressure from many sides to ease monetary policy in order to revitalize the economy and end the recession. The Administration has publicly suggested that the Fed has not gone far enough in easing credit, and even Fed Chairman Alan Greenspan is known to have favored moving more aggressively against the recession earlier this spring. His view turned out to be in the minority among the Fed policymakers at the time, and further easing was delayed.

This article does not seek to suggest that the Fed should ease rates further today, although many have made that case. Rather, the point of this article is to show the tradeoffs the Fed faces in deciding whether to ease monetary policy another notch or whether to hold fast. By using an econometric model of the U.S. economy, we will uncover some of the shifts that can result from a change in credit policy. We will use a ten-year simulation of the economy to judge its impact on measures such as GNP growth, unemployment, inflation, and housing starts.

The following section presents the Fed's overall objectives in setting monetary policy. This is followed by a simplified overview of the mechanics of putting the new policy in place and a section on the dangers of easing too much. Before looking at the results of the simulation, we'll briefly describe how the Federal Reserve has responded during the current recession.

The Name of the Game

The Fed's goal is to promote long-term, noninflationary economic growth. Over the long term, providing growth and price stability are not incompatible; in fact, real price stability, as opposed to low inflation, would boost strong economic growth. In the short-term, however, there is a trade-off between growth and inflation. We can have greater growth today at the cost of higher inflation later, or we can slow economic growth now for the rewards of lower inflation later. The Fed took the latter course in the late 1980s under its so-called soft landing policy. Today the Fed must determine how to alter monetary policy so that economic recovery is encouraged without setting the stage for greater inflation later.

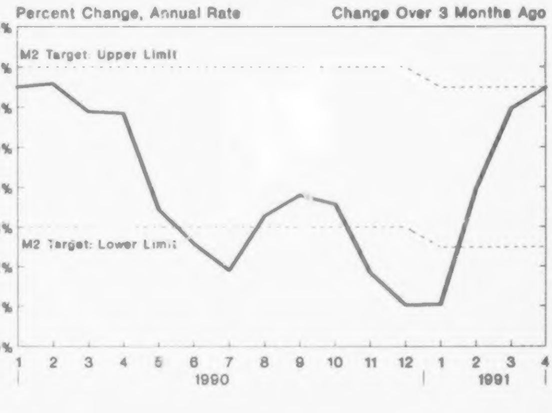
How The Game Is Played

Although the Federal Reserve is often exhorted to lower interest rates, it doesn't set any market interest rates, strictly speaking. It does set the discount rate, but that's only for borrowing between the Fed and individual banks. The market interest rate most affected by the Fed is the rate that's charged for overnight loans between banks. Known as the fed funds rate, it moves in response to supply and demand conditions among banks as they seek to cover their reserve requirements. The Fed influences the fed funds rate to move toward the target it has set by affecting reserve availability.

In easing monetary policy, the Fed supplies more reserves to the banking system. With a greater supply of reserves on hand, and everything else being equal, the fed funds rate drops. Banks have more funds to loan out, and, so the story goes, more loans are made to fuel economic activity. In a competitive marketplace, loan rates for consumer and business lending fall. Businesses are more likely to borrow funds for expansion, and consumers are more likely to borrow to buy new cars, new homes, vacations, appliances, and so forth. This stimulation of demand means more products are required, and so employment and incomes rise as well.

Time is required for the Fed's easing to work through the economy, and it may be months after the fact before the Fed learns the impact of their policy change. One early signal is thought to be the money supply, since the new loans are generally funneled through checking accounts, which are part of the money supply. Consequently, growth in the money supply is seen as an indicator of economic activity. Recent growth in the money supply measure known as M2 is pictured below, and the below-target growth in late 1990 led many to feel that the Fed

Money Supply Growth Bounces Back



needed to ease further. Growth has rebounded in recent months, and some may take this as a signal that the credit easing of earlier months is passing through the system.

The Risk of Easing Too Much

With the benefit of stronger economic growth, why doesn't the Fed simply ease? There is a serious downside to a monetary policy that's too loose: inflation. With the extra credit available, consumers and businesses begin demanding more goods and services before suppliers have produced them. If the money has been created too quickly, then demand outstrips supply and, in a competitive marketplace, the increased demand causes prices to rise. Eventually, the rising prices lead workers to seek higher wage and salary increases, and this in turn leads to higher costs for suppliers. An inflationary cycle has been kicked off, with the result that suppliers, after initially boosting production, begin to cut back output. Concerned about high inflation, the monetary authorities then scale back credit availability, interest rates rise, and demand cools off. As it turns out, the seed of the boom-bust cycle is usually poorly-handled monetary policy.

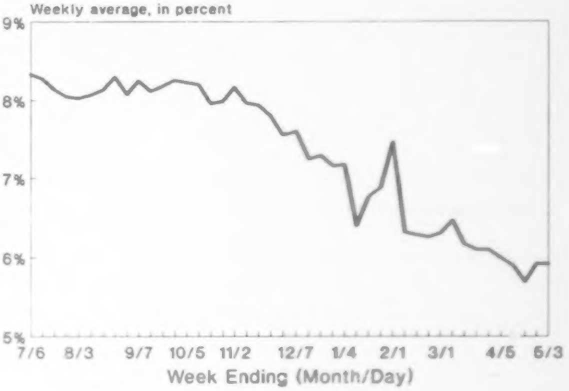
To avoid an inflationary cycle (or a deflationary episode such as the Great Depression), the increase in money created by the Fed must match the growth in the output of goods and services in the economy. In other words, the source of new wealth in the economy is increased production, not the creation of new money by the Federal Reserve.

While discussing the nature of inflation, it's worth pointing out that there is no one rate of inflation, and its impact is not uniform on the various sectors of the economy. Because inflation affects manufacturing differently than services, for example, it distorts the judgement of the true cost of one activity relative to another. It's the price system that coordinates economic activity in a free market, and the additional static inflation adds to the transmission of prices throughout the economy is costly.

What The Fed Has Done So Far In This Recession

The fed funds rate hovered around 8.25 percent during the first half of 1990. This was about 2 percentage points higher than it was in early 1988, when the Fed launched its soft-landing initiative in order to lower inflation. After detecting the discomfort of the credit crunch in some areas, the Fed lowered its fed funds target rate to 8 percent in July. In October, at the conclusion of the federal budget negotiations, another one-quarter point drop in the target was announced. Since then, as the weakness in the economy grew increasingly evident, the Fed has increased reserve availability such that the fed funds rate is currently averaging just under 6 percent. In addition, the Fed eliminated some reserve requirements in December, which also released loanable funds to the banking system.

The Fall in the Fed Funds Rate



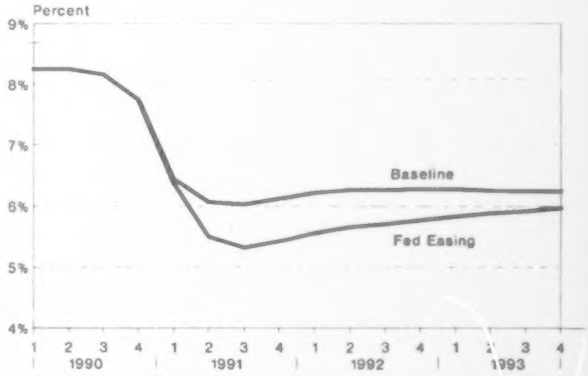
Now the question is: Having eased this much over the past 10 months or so, should the Fed sit tight and let its monetary tonic take effect? Or, in light of the credit crunch and the lack of a vibrant sector that could lead us out of recession, should the Fed ease further?

The Simulation Results

By now we've set the stage to discuss the model simulation. The first step was to develop a baseline case, against which we can compare the results of the experiment. To show the full, long-term effects of the Federal Reserve's actions, a projection was prepared using a ten-year forecast horizon, which allows the economic effects enough time to work their way through the economy. The first three years of the forecast, 1991-93, replicate NAR's April forecast, and the remaining seven years show an economy growing close to its long-term trend.

An alternative projection was prepared to compare

The Simulation Experiment:
The Change in the Federal Funds Rate



Simulation Results for Selected Variables

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Real GNP Growth *percent change*											
Baseline	1.0	-0.2	2.9	2.8	2.1	2.5	3.1	2.9	3.1	2.4	2.2
Fed Easing	1.0	0.0	3.6	3.4	2.0	2.0	2.6	2.3	2.7	2.6	2.4
Unemployment Rate *percent*											
Baseline	5.5	6.8	6.4	5.9	6.0	6.1	5.8	5.7	5.5	5.5	5.7
Fed Easing	5.5	6.7	6.0	5.3	5.5	5.8	5.8	6.0	6.0	6.0	6.1
Consumer Prices *percent change*											
Baseline	5.4	4.4	3.4	3.5	2.8	3.1	3.0	2.9	2.9	2.9	2.9
Fed Easing	5.4	4.4	3.5	4.0	3.5	3.9	3.7	3.4	3.1	2.9	2.7
Short-Term Interest Rates *percent*											
Baseline	7.5	5.9	5.8	5.8	5.3	5.3	5.3	5.2	5.2	5.0	4.9
Fed Easing	7.5	5.4	5.3	5.5	5.2	5.2	5.2	5.1	5.1	5.0	4.8
Long-Term Interest Rates *percent*											
Baseline	8.6	8.1	7.8	7.6	7.1	6.9	6.8	6.7	6.7	6.6	6.4
Fed Easing	8.6	7.9	7.5	7.3	6.8	6.7	6.7	6.6	6.6	6.5	6.4
Mortgage Rates *percent*											
Baseline	10.1	9.2	8.9	8.8	8.2	8.0	7.9	7.8	7.8	7.7	7.5
Fed Easing	10.1	9.0	8.5	8.5	7.9	7.8	7.8	7.7	7.7	7.6	7.4
Housing Starts *thousands of units*											
Baseline	1,202	1,055	1,266	1,342	1,351	1,395	1,427	1,385	1,314	1,230	1,233
Fed Easing	1,202	1,080	1,325	1,378	1,346	1,386	1,403	1,343	1,277	1,213	1,206

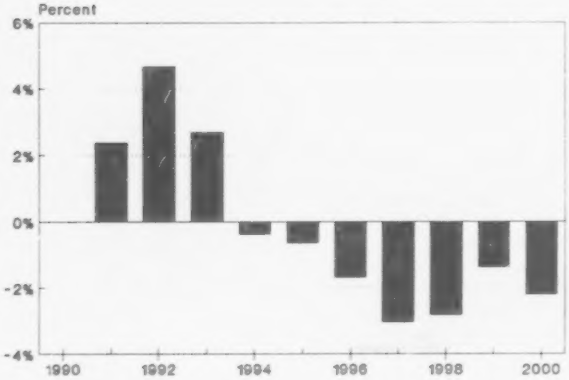
with the baseline simulation. In the alternative, credit growth is expanded enough to cause the fed funds rate to fall from about 6 percent to about 5.5 percent for two quarters in 1991. Growth in credit is then brought up gradually to the same rate so that by 1993 and beyond the growth assumptions in the two simulations are identical (see the chart comparing the two fed funds rates). Consequently, the only difference in the assumptions underlying the two simulations is this ease in credit policy in 1991-92. All of the changes in the other variables, as presented in the table, result from this difference of assumptions.

A more aggressive easing assumption would have magnified the differences between the two simulations, but a half-point decline in the fed funds rate was chosen since it is a reasonable alternative for the Fed to consider in today's situation and still produces measurable differences between the two simulations.

A look at several key variables will illustrate the tradeoffs the Fed faces as it considers easing monetary policy:

Real GNP: As expected, the Fed easing produces stronger growth in the short run. Total production in the economy, measured in after-inflation dollars, is up 3.6 percent in 1992 in the easing scenario; in the baseline projection, real GNP rises 2.9 percent. By 1993, goods and services valued at an extra $66.9 billion have been produced. But the gap between the two simulations shrinks after 1993, and, as the economy grapples with higher inflation, output growth in the easing scenario declines below that of the baseline. By the year 2000, the

A Wash in the Long-Run: The Difference in Housing Starts



economy is at virtually the same spot in the two simulations: $5,256 billion in the base case, $5,252 billion in the easing case, a difference of less than one-tenth of one percentage point.

Unemployment Rate: Following the lead of GNP, the unemployment rate improves in the first three years of the simulation relative to the baseline, falling to the pre-recession level of 5.3 percent in 1993. But again, economic performance has been hampered in the later years, and the gap between the two unemployment rates closes by 1996. In the final four years, the rate in the easing scenario exceeds that of the baseline case.

Consumer Price Index: The cost of greater output in the short-run is apparent in the comparison between the rates of inflation. For seven consecutive years, the CPI grows faster in the easing simulation than it does in the baseline case.

Interest Rates on Government Securities: The short-term interest rate (in this case the 3-month Treasury Bill) is more responsive to the Fed's easing, falling a half-percentage point immediately in 1991. The long-term rate (30-year Treasury Bond) falls as well, but only by three-tenths of a point at its widest. In both cases the gap between the two simulations narrows over time.

Housing Market: Mortgage rates fall faster in the easing scenario, and the rebound in the housing market is consequently stronger. In 1992, housing starts in the easing case are higher by 59,000 units, or almost 5 percent (see chart). After the first three years of the simulation, the advantage swings over to the baseline scenario. In the ten years of the simulation, housing starts totaled 12,998,000 units in the base case and 12,957,000 units in the alternative case, a difference over ten years of 41,000 units, or three-tenths of one percent.

Another alternative is for the Fed to ease now, but, beginning in 1993, tighten credit policy further than we have assumed in our simulation. This action would be designed to choke off the extra inflation induced by the easing of the early 1990s. However, because of monetary policy's time lag and the difficulty in pinpointing our present position and course, such fine-tuning is extremely difficult. The tools the Fed has to work with are crude, not precise, and the economy is as nimble at changing course as an ocean liner.

Conclusion

The answer for the Fed is not obvious, and it may rest on the assumptions made about the economy's initial conditions. In our scenario, the economy is assumed to post a marginally positive growth rate in the second quarter of 1991, with the first quarter of solid growth coming in the following quarter. If we're wrong, and the economy continues to decline significantly in the second and third quarters of 1991, then we may wish the Fed had eased more today. On the other hand, if the economy is able to shake off its slumber sooner than expected and robust growth returns in the second quarter, we may be glad that the Fed didn't go further in easing credit policy. Stoking the credit furnace up too much may, by the time the fire spreads, produce too much inflationary heat later.

by Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis

Note. Simulations were run on the Laurence H. Meyer & Associates' model of the U.S. economy.

These historical tables are a new feature
and will appear in the February, May, August and November
issues of the Real Estate Outlook.

Economic Indicators

	GNP	CPI	Unemployment Rate	Mortgage Rate	Short-Term Rate	Long-Term Rate
	Percent Change	*Percent Change*	*Percent*	*Percent*	*Percent*	*Percent*
Annual						
1980	-0.2	13.5	7.2	13.8	11.4	11.3
1981	1.9	10.4	5.8	10.6	9.4	9.0
1982	-2.5	6.2	6.4	12.9	11.1	10.3
1983	3.6	3.2	9.6	13.2	8.6	11.2
1984	6.8	4.4	7.5	13.9	9.5	12.4
1985	3.4	3.5	7.2	12.4	7.5	10.8
1986	2.7	1.9	7.0	10.2	6.0	7.8
1987	3.4	3.7	6.2	10.2	5.8	8.6
1988	4.5	4.1	5.5	10.3	6.7	9.0
1989	2.5	4.8	5.3	10.3	8.1	8.4
1990	1.0	5.4	5.5	10.1	7.5	8.6
Quarterly						
1984:1	10.7	5.8	7.9	13.3	9.2	12.0
2	5.5	3.8	7.4	14.0	9.8	13.2
3	2.6	3.5	7.4	14.5	10.3	12.7
4	1.7	3.5	7.3	13.7	8.8	11.7
1985:1	4.9	3.7	7.2	13.1	8.2	11.6
2	2.4	3.7	7.3	12.8	7.5	11.0
3	4.1	2.5	7.2	12.1	7.1	10.6
4	3.0	4.1	7.0	11.7	7.2	10.0
1986:1	6.6	2.1	7.0	10.6	6.9	8.8
2	-1.8	-1.9	7.2	10.3	6.1	7.5
3	0.8	2.5	7.0	10.2	5.5	7.4
4	2.3	2.8	6.8	9.7	5.4	7.5
1987:1	5.2	5.4	6.6	9.1	5.5	7.5
2	4.2	4.5	6.3	10.3	5.7	8.5
3	4.1	4.1	6.0	10.5	6.0	9.1
4	6.6	3.8	5.8	10.9	5.9	9.2
1988:1	5.1	3.2	5.7	10.1	5.7	8.6
2	3.6	4.7	5.5	10.4	6.2	9.1
3	2.7	5.2	5.5	10.5	7.0	9.2
4	2.7	4.3	5.3	10.4	7.7	9.0
1989:1	3.6	5.0	5.2	10.8	8.5	9.0
2	1.6	6.2	5.3	10.7	8.4	8.7
3	1.7	3.2	5.3	10.0	7.8	8.1
4	0.3	4.0	5.3	9.8	7.7	7.9
1990:1	1.7	7.4	5.3	10.1	7.8	8.4
2	0.4	3.9	5.3	10.3	7.7	8.7
3	1.4	6.9	5.6	10.1	7.5	8.8
4	-1.6	7.0	5.9	10.0	7.0	8.5
1991:1	-2.8	3.5	6.5	9.5	6.0	8.2

Note: Quarterly levels and percentages are annualized. Quarterly figures may not average to annual figures due to rounding. The 3-Month Treasury Bill is shown as "Short-Term Rate"; The 30-Year Treasury Bond is shown as "Long-Term Rate."

Housing Starts

Thousands of Units, Seasonally Adjusted; Percent Change

	Total		Single-Family		Multi-Family	
Annual						
1980	1,300	-24.3	855	-27.0	445	-18.4
1981	1,096	-15.7	711	-16.9	386	-13.4
1982	1,057	-3.6	663	-6.7	394	2.3
1983	1,705	61.3	1,065	60.6	641	62.4
1984	1,768	3.7	1,098	3.1	669	4.5
1985	1,741	-1.5	1,071	-2.5	671	0.2
1986	1,812	4.0	1,182	10.4	630	-6.1
1987	1,631	-10.0	1,154	-2.4	476	-24.3
1988	1,488	-8.7	1,083	-6.2	405	-15.0
1989	1,381	-7.2	1,005	-7.2	376	-7.2
1990	1,203	-12.9	901	-10.4	302	-19.7
Quarterly						
1984:1	1,940	12.2	1,221	16.0	719	6.3
2	1,829	-5.7	1,103	-9.6	726	1.0
3	1,671	-8.7	1,004	-9.0	667	-8.1
4	1,630	-2.4	1,066	6.2	565	-15.4
1985:1	1,714	5.2	1,064	-0.2	650	15.2
2	1,726	0.7	1,053	-1.0	673	3.4
3	1,701	-1.4	1,059	0.6	642	-4.6
4	1,825	7.3	1,108	4.6	717	11.7
1986:1	1,899	4.1	1,198	8.1	701	-2.2
2	1,878	-1.1	1,215	1.5	663	-5.5
3	1,759	-6.4	1,161	-4.4	597	-9.9
4	1,712	-2.6	1,155	-0.5	557	-6.8
1987:1	1,761	2.9	1,237	7.1	524	-5.9
2	1,612	-8.5	1,138	-8.0	474	-9.6
3	1,625	0.8	1,163	2.2	462	-2.5
4	1,524	-6.2	1,079	-7.3	445	-3.7
1988:1	1,425	-6.5	1,057	-2.0	368	-17.2
2	1,491	4.6	1,066	0.9	425	15.3
3	1,484	-0.4	1,071	0.5	413	-2.8
4	1,551	4.5	1,137	6.1	414	0.4
1989:1	1,464	-5.6	1,026	-9.8	438	5.8
2	1,360	-7.1	999	-2.7	362	-17.5
3	1,348	-0.9	1,003	0.4	346	-4.4
4	1,352	0.2	994	-0.9	358	3.5
1990:1	1,433	6.0	1,064	7.1	369	3.2
2	1,204	-16.0	896	-15.8	308	-16.5
3	1,131	-6.1	856	-4.4	274	-10.9
4	1,042	-7.8	786	-8.2	256	-6.7
1991:1	937	-10.1	726	-7.7	211	-17.4

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

Housing Starts by Region

Thousands of Units, Seasonally Adjusted; Percent Change

	Northeast		Midwest		South		West	
Annual								
1980	125	-30.9	218	-34.0	647	-12.6	309	-33.4
1981	117	-6.5	175	-19.7	565	-12.7	239	-22.8
1982	113	-3.2	142	-18.8	596	5.4	206	-13.7
1983	171	50.8	217	52.8	937	57.3	380	84.5
1984	207	20.7	247	13.6	873	-6.8	440	15.7
1985	249	20.8	237	-4.0	785	-10.1	470	6.8
1986	298	19.5	298	25.8	732	-6.8	484	3.0
1987	269	-9.7	308	3.3	633	-13.5	420	-13.1
1988	239	-11.4	272	-11.9	574	-9.3	404	-3.9
1989	181	-24.1	269	-1.1	535	-6.7	397	-1.9
1990	135	-25.2	259	-3.7	478	-10.6	330	-16.7
Quarterly								
1984:1	201	29.4	269	29.1	976	0.8	494	24.2
2	197	-1.8	252	-6.2	922	-5.5	451	-8.7
3	195	-1.4	233	-7.7	825	-10.6	420	-6.9
4	233	19.7	234	0.3	768	-6.8	395	-5.8
1985:1	228	-2.3	222	-4.9	790	2.8	474	20.0
2	260	14.3	243	9.1	765	-3.1	457	-3.6
3	230	-11.7	236	-2.9	755	-1.4	481	5.1
4	280	21.6	248	5.2	830	10.0	467	-2.8
1986:1	315	12.6	294	18.5	809	-2.5	481	2.9
2	290	-7.9	298	1.5	776	-4.1	514	6.9
3	299	3.1	302	1.1	706	-9.0	452	-12.0
4	288	-3.7	300	-0.7	636	-9.9	489	8.1
1987:1	285	-0.9	372	24.1	633	-0.5	471	-3.5
2	273	-4.3	296	-20.3	631	-0.3	412	-12.7
3	265	-3.1	281	-5.1	658	4.3	421	2.3
4	254	-4.2	283	0.7	609	-7.4	377	-10.4
1988:1	278	9.7	235	-17.1	532	-12.6	380	0.6
2	236	-15.1	290	23.4	583	9.5	382	0.5
3	234	-1.1	266	-8.4	578	-0.9	407	6.6
4	206	-12.0	296	11.3	602	4.2	448	10.1
1989:1	211	2.4	283	-4.2	571	-5.1	399	-10.9
2	185	-12.2	250	-11.8	532	-6.8	393	-1.5
3	168	-9.4	256	2.5	531	-0.3	393	0.1
4	161	-4.2	284	10.9	506	-4.7	401	1.9
1990:1	172	7.3	308	8.4	538	6.3	415	3.5
2	122	-29.2	260	-15.8	495	-8.0	327	-21.1
3	114	-6.8	235	-9.5	457	-7.7	325	-0.7
4	134	17.6	232	-1.4	423	-7.4	254	-21.9
1991:1	91	-31.9	231	-0.3	381	-10.1	211	-16.8

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

New Home Sales

Thousands of Units, Seasonally Adjusted; Percent Change

	U.S.		Northeast		Midwest		South		West	
Annual										
1980	545	-22.5	51	-25.6	81	-27.3	269	-11.1	145	-34.8
1981	436	-20.1	46	-8.4	60	-26.1	218	-18.9	112	-23.1
1982	418	-4.0	47	2.0	48	-20.1	223	2.3	100	-10.0
1983	627	50.0	76	61.1	71	48.9	328	47.0	152	51.7
1984	637	1.5	90	18.8	76	7.0	310	-5.5	161	5.4
1985	691	8.6	110	22.0	82	8.1	325	4.9	174	8.4
1986	746	8.0	134	21.4	95	15.5	320	-1.6	197	13.5
1987	669	-10.4	117	-12.7	97	2.5	269	-16.0	186	-5.9
1988	675	0.9	101	-13.8	98	0.1	271	0.7	206	10.6
1989	654	-3.1	90	-10.8	103	6.1	258	-4.8	202	-1.7
1990	532	-18.5	74	-17.6	90	-13.5	223	-13.7	146	-27.6
Quarterly										
1984:1	676	-1.0	86	12.7	76	0.4	336	-9.1	179	10.7
2	628	-7.1	86	0.8	79	3.9	301	-10.3	162	-9.7
3	616	-1.9	99	15.1	74	-6.3	302	0.3	140	-13.2
4	627	1.8	90	-9.7	75	1.8	301	-0.2	161	14.7
1985:1	666	6.2	100	11.9	85	12.8	320	6.3	160	-0.4
2	673	1.1	104	3.3	79	-7.5	323	0.9	168	4.6
3	723	7.4	117	13.2	84	7.2	333	3.0	189	12.5
4	703	-2.8	119	1.4	81	-4.0	325	-2.5	179	-5.1
1986:1	780	11.0	138	16.2	89	10.3	349	7.4	204	13.8
2	791	1.4	142	2.4	99	10.8	336	-3.5	215	5.4
3	694	-12.3	123	-13.4	90	-8.8	299	-11.2	182	-15.2
4	720	3.7	132	7.6	101	12.2	297	-0.4	189	4.0
1987:1	718	-0.3	126	-4.8	106	4.9	293	-1.3	192	1.6
2	674	-6.1	108	-13.8	100	-6.3	278	-5.1	188	-2.4
3	660	-2.1	118	8.9	87	-12.4	271	-2.6	184	-1.8
4	623	-5.6	115	-2.5	96	10.3	234	-13.8	179	-2.9
1988:1	632	1.4	105	-8.7	96	0.0	255	9.1	176	-1.7
2	697	10.2	111	5.4	94	-2.1	287	12.4	205	16.3
3	695	-0.3	97	-12.0	97	2.5	279	-2.6	221	8.1
4	676	-2.7	90	-7.9	103	6.2	263	-5.7	220	-0.5
1989:1	628	-7.1	102	13.4	103	0.0	237	-9.9	186	-15.6
2	636	1.3	81	-20.3	99	-3.6	257	8.4	198	6.5
3	699	10.0	84	4.1	110	10.8	278	8.2	226	14.3
4	652	-6.8	92	9.1	102	-6.7	260	-6.7	198	-12.7
1990:1	597	-8.4	84	-9.1	95	-7.5	240	-7.4	179	-9.6
2	539	-9.7	79	-6.0	92	-3.2	219	-8.9	150	-15.9
3	523	-3.0	65	-16.9	91	-0.7	229	4.7	137	-8.6
4	470	-10.3	68	4.1	81	-11.4	203	-11.5	119	-13.6
1991:1	461	-1.8	49	-27.5	87	7.4	193	-5.1	132	11.5

Note: Quarterly levels are annualized. Simple percent changes are shown. Quarterly figures may not average to annual figures due to rounding.

Existing Home Sales

Thousands of Units, Seasonally Adjusted; Percent Change

	U.S.		Northeast		Midwest		South		West	
Annual										
1980	2,973	-22.3	403	-23.4	806	-24.0	1,092	-19.3	672	-24.2
1981	2,419	-18.6	353	-12.4	632	-21.6	917	-16.0	516	-23.2
1982	1,990	-17.7	354	0.3	490	-22.5	780	-14.9	366	-29.1
1983	2,719	36.6	493	39.3	709	44.7	1,035	32.7	481	31.4
1984	2,868	5.5	511	3.7	755	6.5	1,073	3.7	529	10.0
1985	3,214	12.1	622	21.7	866	14.7	1,172	9.2	554	4.7
1986	3,565	10.9	703	13.1	991	14.4	1,261	7.6	610	10.1
1987	3,526	-1.1	685	-2.6	959	-3.2	1,282	1.7	600	-1.6
1988	3,594	1.9	673	-1.8	929	-3.1	1,350	5.3	642	7.0
1989	3,440	-4.3	589	-12.5	919	-1.1	1,307	-3.2	610	-5.0
1990	3,296	-4.2	522	-11.4	892	-2.9	1,325	1.4	557	-8.7
Quarterly										
1984:1	2,927	4.8	500	0.0	783	10.8	1,103	2.2	540	7.3
2	2,983	1.9	523	4.7	777	-0.9	1,123	1.8	557	3.1
3	2,763	-7.4	510	-2.5	723	-6.9	1,027	-8.6	507	-9.0
4	2,800	1.3	507	-0.7	737	1.8	1,040	1.3	510	0.7
1985:1	2,993	6.9	560	10.5	783	6.3	1,127	8.3	530	3.9
2	3,070	2.6	583	4.2	823	5.1	1,123	-0.3	543	2.5
3	3,370	9.8	657	12.6	933	13.4	1,217	8.3	563	3.7
4	3,423	1.6	683	4.1	930	-0.4	1,227	0.8	580	3.0
1986:1	3,340	-2.4	683	0.0	927	-0.4	1,167	-4.9	557	-4.0
2	3,493	4.6	690	1.0	1,013	9.4	1,213	4.0	583	4.8
3	3,593	2.9	693	0.5	990	-2.3	1,293	6.6	617	5.7
4	3,833	6.7	747	7.7	1,033	4.4	1,377	6.4	680	10.3
1987:1	3,693	-3.7	713	-4.5	1,077	4.2	1,300	-5.6	607	-10.8
2	3,613	-2.2	697	-2.3	977	-9.3	1,317	1.3	623	2.7
3	3,427	-5.2	677	-2.9	900	-7.8	1,263	-4.1	587	-5.9
4	3,333	-2.7	653	-3.4	887	-1.5	1,233	-2.4	567	-3.4
1988:1	3,297	-1.1	643	-1.5	890	0.4	1,207	-2.2	557	-1.8
2	3,600	9.2	683	6.2	933	4.9	1,350	11.9	630	13.2
3	3,630	0.8	673	-1.5	933	0.0	1,360	0.7	660	4.8
4	3,690	1.7	660	-2.0	953	2.1	1,410	3.7	663	0.5
1989:1	3,547	-3.9	627	-5.1	920	-3.5	1,337	-5.2	660	-0.5
2	3,340	-5.8	577	-8.0	890	-3.3	1,267	-5.2	603	-8.6
3	3,443	3.1	590	2.3	947	6.4	1,317	3.9	587	-2.8
4	3,537	2.7	593	0.6	967	2.1	1,360	3.3	617	5.1
1990:1	3,443	-2.6	543	-8.4	943	-2.4	1,350	-0.7	607	-1.6
2	3,363	-2.3	517	-4.9	930	-1.4	1,330	-1.5	583	-3.8
3	3,297	-2.0	530	2.6	907	-2.5	1,310	-1.5	547	-6.3
4	3,117	-5.5	500	-5.7	853	-5.9	1,260	-3.8	497	-9.1
1991:1	3,080	-1.2	493	-1.3	887	3.9	1,190	-5.6	507	2.0

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

Existing Home Prices

Dollars

	U.S.		Northeast		Midwest		South		West	
Annual										
1980	62,200	12.0	60,800	14.1	51,900	8.8	58,300	13.9	89,300	15.0
1981	66,400	6.8	63,700	4.8	54,300	4.6	64,400	10.5	96,200	7.7
1982	67,800	2.1	63,500	-0.3	55,100	1.5	67,100	4.2	98,900	2.8
1983	70,300	3.7	72,200	13.7	56,600	2.7	69,200	3.1	94,900	-4.0
1984	72,400	3.0	78,700	9.0	57,100	0.9	71,300	3.0	95,800	0.9
1985	75,500	4.3	88,900	13.0	58,900	3.2	75,200	5.5	95,400	-0.4
1986	80,300	6.4	104,800	17.9	63,500	7.8	78,200	4.0	100,900	5.8
1987	85,600	6.6	133,300	27.2	66,000	3.9	80,400	2.8	113,200	12.2
1988	89,300	4.3	143,000	7.3	68,400	3.6	82,200	2.2	124,900	10.3
1989	93,100	4.3	145,200	1.5	71,300	4.2	84,500	2.8	139,900	12.0
1990	95,500	2.6	141,200	-2.8	74,000	3.8	85,900	1.7	139,600	-0.2
Quarterly										
1984:1	71,300	1.8	75,267	3.7	57,200	3.2	70,133	1.3	96,467	1.8
2	72,733	2.0	77,667	3.2	58,133	1.6	71,967	2.6	96,033	-0.4
3	73,200	0.6	80,133	3.2	57,167	-1.7	72,033	0.1	95,867	-0.2
4	71,967	-1.7	81,733	2.0	55,267	-3.3	70,833	-1.7	94,900	-1.0
1985:1	74,133	3.0	86,267	5.5	58,367	5.6	73,533	3.8	93,500	-1.5
2	75,500	1.8	88,333	2.4	59,400	1.8	75,200	2.3	94,567	1.1
3	76,600	1.5	89,467	1.3	59,400	0.0	76,767	2.1	97,367	3.0
4	75,200	-1.8	91,300	2.0	58,100	-2.2	74,533	-2.9	95,700	-1.7
1986:1	78,100	3.9	98,867	8.3	62,167	7.0	77,433	3.9	95,700	0.0
2	82,000	5.0	106,567	7.8	65,333	5.1	80,433	3.9	101,433	6.0
3	80,733	-1.5	106,033	-0.5	63,567	-2.7	78,233	-2.7	101,567	0.1
4	80,200	-0.7	107,233	1.1	62,433	-1.8	75,867	-3.0	101,533	-0.0
1987:1	84,567	5.4	124,467	16.1	66,967	7.3	80,933	6.7	106,867	5.3
2	85,967	1.7	134,400	8.0	66,433	-0.8	81,567	0.8	111,933	4.7
3	86,767	0.9	138,167	2.8	66,200	-0.4	80,433	-1.4	116,567	4.1
4	85,000	-2.0	134,700	-2.5	64,400	-2.7	79,367	-1.3	116,533	-0.0
1988:1	88,633	4.3	138,267	2.6	67,433	4.7	82,800	4.3	119,367	2.4
2	89,267	0.7	144,133	4.2	68,867	2.1	83,033	0.3	122,600	2.7
3	90,233	1.1	144,867	0.5	68,900	0.0	83,167	0.2	126,833	3.5
4	88,700	-1.7	142,700	-1.5	67,700	-1.7	79,700	-4.2	129,867	2.4
1989:1	91,167	2.8	143,400	0.5	69,367	2.5	84,067	5.5	133,633	2.9
2	93,000	2.0	145,833	1.7	70,900	2.2	84,867	1.0	139,400	4.3
3	94,933	2.1	147,067	0.8	72,500	2.3	85,733	1.0	145,300	4.2
4	92,667	-2.4	144,100	-2.0	71,833	-0.9	82,833	-3.4	140,867	-3.1
1990:1	95,467	3.0	144,900	0.6	73,167	1.9	85,433	3.1	143,367	1.8
2	96,600	1.2	143,500	-1.0	74,633	2.0	86,767	1.6	139,433	-2.7
3	96,567	-0.0	141,900	-1.1	75,133	0.7	87,300	0.6	138,200	-0.9
4	92,200	-4.5	134,933	-4.9	72,033	-4.1	83,167	-4.7	137,667	-0.4
1991:1	95,367	3.4	138,800	2.9	75,700	5.1	85,100	2.3	141,433	2.7

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

U.S. Economic Outlook: May 1991

Quarterly figures are seasonally adjusted annual rates

	90.4	91.1	91.2	91.3	91.4	92.1	92.2	92.3	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-1.6	-2.8	-0.2	2.1	2.7	3.6	3.2	2.9	2.5	1.0	-0.4	2.8	2.8
Industrial Production	-7.2	-9.2	-2.1	2.7	4.3	5.4	5.3	5.2	2.6	1.0	-2.8	4.3	4.9
Civilian Employment	-0.9	-2.4	-0.5	0.6	0.5	0.8	1.1	1.4	2.0	0.5	-0.9	0.8	1.3
GNP Inflation Index	2.8	5.5	4.2	3.6	3.2	3.3	2.8	3.0	4.1	4.1	4.1	3.2	2.9
Consumer Prices	7.0	3.5	3.8	3.7	3.4	3.4	3.4	3.9	4.8	5.4	4.7	3.5	3.5
Value of the U.S. Dollar	-19.0	8.0	41.4	6.2	1.9	0.3	1.1	0.9	6.2	-9.6	2.3	3.7	-0.6
Percent													
Mfg. Capacity Utilization	80.8	78.1	77.4	77.7	78.2	79.0	79.8	80.6	83.9	82.3	77.8	80.2	83.2
Civilian Unemployment	5.9	6.5	6.8	7.0	7.1	6.9	6.7	6.6	5.3	5.5	6.9	6.7	6.2
Percent of GNP													
Federal Tax Receipts	20.4	20.5	20.5	20.5	20.5	20.7	20.7	20.7	20.2	20.3	20.5	20.7	20.7
Federal Expenditures	23.7	22.4	22.2	24.2	24.0	24.2	23.9	23.8	22.8	23.3	23.2	23.9	23.3
Federal Budget Deficit	-3.3	-1.9	-1.7	-3.7	-3.5	-3.5	-3.2	-3.1	-2.6	-3.0	-2.7	-3.2	-2.6
Interest Rates, Percent													
Federal Funds Rate	7.7	6.4	5.8	5.8	6.0	6.5	6.5	6.4	9.2	8.1	6.0	6.4	6.4
3-Month T-Bill Rate	7.0	6.0	5.6	5.6	5.7	6.2	6.2	6.1	8.1	7.5	5.7	6.1	7.8
Prime Rate	10.0	9.2	8.7	8.5	8.5	8.8	8.8	8.8	10.9	10.0	8.7	8.7	8.5
Discount Rate	6.9	6.2	5.7	5.5	5.5	5.8	6.0	6.0	6.9	7.0	5.7	5.9	6.0
Corporate AAA Bond Yield	9.3	8.9	8.7	8.5	8.4	8.5	8.6	8.5	9.3	9.3	8.6	8.5	8.1
30-Year Government Bond Yield	8.5	8.2	8.1	7.9	7.9	8.0	8.1	8.0	8.4	8.6	8.0	8.0	7.8
Mortgage Rates, Percent													
30-Year Fixed Rate	10.0	9.5	9.3	9.1	9.0	9.0	8.9	9.0	10.3	10.1	9.2	9.0	9.2
1-Year Adjustable	8.4	8.1	7.8	7.5	7.3	7.3	7.4	7.4	9.3	8.4	7.7	7.4	7.5
Home Sales & Starts													
Thousands													
Total Single-Family Sales (Single-family resales plus 97% of single-family starts)	3,879	3,778	3,875	4,119	4,264	4,427	4,474	4,526	4,442	4,179	4,009	4,497	4,649
Existing Single-Family Sales	3,117	3,080	3,146	3,303	3,411	3,520	3,545	3,583	3,467	3,305	3,235	3,564	3,660
New Single-Family Sales	470	461	516	534	573	582	600	611	654	533	521	604	645
Housing Starts	1,042	914	963	1,040	1,094	1,156	1,212	1,247	1,381	1,203	1,003	1,221	1,321
Single-Family Units	786	719	751	842	879	935	957	972	1,005	901	798	962	1,020
Multi-Family Units	256	194	212	198	215	221	255	275	376	302	205	259	301
2-4 Family Units	31	33	36	34	36	38	43	47	56	37	35	44	51
5+ Family Units	225	161	176	164	178	183	212	229	320	264	170	215	250
Mobile Homes Shipped	178	160	162	167	170	175	175	175	199	188	165	174	169
Percent change -- Year Ago													
Total Single-Family Sales	-13.8	-15.6	-8.5	-0.2	9.9	17.2	15.5	9.9	-4.4	-5.9	-4.1	12.2	3.4
Existing Single-Family Sales	-11.9	-10.6	-6.5	0.2	9.4	14.3	12.7	8.5	-3.6	-4.7	-2.1	10.2	2.7
New Single-Family Sales	-27.9	-22.8	-4.3	2.0	21.9	26.3	16.3	14.4	-3.3	-18.5	-2.2	15.9	6.8
Housing Starts	-22.9	-36.3	-20.0	-8.0	4.9	26.5	25.9	20.0	-7.2	-12.9	-16.6	21.8	8.2
Single-Family Units	-20.9	-32.4	-16.2	-1.7	11.8	30.0	27.4	15.5	-7.2	-10.4	-11.4	20.6	6.0
Multi-Family Units	-28.4	-47.3	-31.3	-27.8	-16.2	13.7	20.5	38.9	-7.2	-19.7	-32.2	26.4	16.3
2-4 Family Units	-42.2	-23.3	-17.1	5.1	17.6	13.7	20.5	38.9	-5.1	-32.8	-6.9	26.4	16.3
5+ Family Units	-26.0	-50.5	-33.6	-32.1	-20.8	13.7	20.5	38.9	-7.6	-17.4	-35.8	26.4	16.3
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	92.2	95.4	96.7	97.7	98.3	100.0	101.4	102.8	92.9	95.2	97.0	102.0	107.2
New Home Prices	122.0	124.5	125.8	126.9	128.8	131.1	132.5	134.1	120.4	122.3	126.5	133.4	140.2
Percent Change - Year Ago													
Existing Home Prices	-0.5	-0.1	0.1	1.1	6.6	4.9	4.8	5.3	4.2	2.4	1.9	5.2	5.1
New Home Prices	-2.0	0.6	-0.7	8.7	5.6	5.3	5.4	5.7	6.2	1.6	3.4	5.4	5.1

Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy. Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of current economic conditions, an easy-to-read forecast for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the Nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets. If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

A-7000-1

Real Estate
OUTLOOK

June 1991

May's payroll employment gain is the most recent of many signals pointing to an imminent recovery. The month's addition of 49,000 workers to private payrolls was the first increase in the past eleven months. Even if it is at hand, however, the recovery is expected to be far from robust. Lackluster consumer spending and personal income gains may prevent any rebound from gaining a firm toehold. Growth in the second half of 1991 is estimated at 2.3%. *Page 2*

For the third consecutive month, the annual rate of existing home sales increased, rising 3.4% in April to an annual sales rate of 3,330,000 units. This pace is the fastest clip in the sales rate since last August. A sign that the Northeast is overcoming its housing slump is the region's gain of 12.8% in its sales rate from March. It now stands almost 4% higher than the level recorded a year earlier. *Page 6*

The median price of existing homes rose over the $100,000 level for the first time. April's 2.0% increase put the price at $100,200 and 4.7% above its level of one year ago. It was only the fourth increase in the past twelve months, but the third gain in the last four. *Page 7*

Also In This Issue:

Demography, Destiny & Economics	*Economic Commentary by John A. Tuccillo*
Outlook for the Economy & Real Estate	*Robert D. Barr & Kimberly A. Martin*
Charting The RTC's Progess: Impacts on Real Estate Markets	*Kimberly A. Martin*

NATIONAL ASSOCIATION OF REALTORS®
REALTOR® *The Voice for Real Estate*™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991
NATIONAL ASSOCIATION OF REALTORS®

Demography, Destiny and Economics

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

On May 23, Bob Dylan turned fifty. But in reality, he's more like 25, frozen in amber for those who came to him and his music at a time when they were puzzling about life and change and independence. Dylan's early work was much more diverse (although less polished or melodious) than the stuff he's done for the last decade or so. It ranged from the familiar protest stuff ("Blowin' in the Wind") to the traditional folk ballad ("North Country Blues") to love songs ("To Ramona") to pure whimsy ("All I Really Want to Do"). But the common thread was the ability of his rasping, nasal voice to capture the imagination of a generation that wanted nothing more than to change the world.

Well, it did, but not in the way it thought. In fact, even before Dylan began to play the coffee houses of Greenwich Village (where millions now claim to have heard him) or burst on the music scene at the Newport Folk Festival, they had already changed the world. For, simply because of its size, the postwar generation has been the driving force in virtually every economic and social event in this country for the past forty plus years. They have been a moving revolution that has shaped the economy we live in, and they will continue to do so in the Nineties.

The Fifties were a decade of growth and migration. We lived less and less in cities and on farms and more and more in the strange new world of suburbia. Part of this derived from the unchallenged economic preeminence of the United States. But even more so, change was predicated on the desires for new family-builders to provide "the best" for the kids. So we built houses and roads and schools and hospitals and all those things that fit the lives of families with young children. Individual firms and whole industries also bloomed. Television came into the house through the kids.

The Sixties are a decade we most often associate with the power of the postwar generation, and it was here that the need for these folks to change the world was born. But the function of adolescents in society has always been to challenge authority. The fact that this generation was so large legitimized that function and caused it to dominate a decade.

That decade featured an economy that became youth-oriented; those industries that catered to the young grew the fastest. Even more importantly, the optimism of the time and the social and political ferment generated by the young opened a new era of government activism that very clearly established the Federal budget as an instrument of economic and social policy.

But the world did not change in the Sixties. When the Seventies dawned, this postwar generation had to go to work, and like a great wave, they crashed on the shore of the labor market and swamped it. The Seventies saw inflation and sluggish economic growth, again the product of a large number of untrained workers.

The surfeit of labor had another impact, as well. At a time when our newly found competitors in Europe and Asia were recapitalizing and adopting cutting edge productive technology, and at a time when our own capital stock was beginning to show signs of wear, industry was reluctant to rebuild itself; it was far more easy to substitute labor for capital. Ultimately, this has cost the American economy by reducing its long run growth and increasing the cost of replacing completely exhausted machinery.

In the Eighties, these folks got the hang of their jobs, settled down and became productive (in both the economic and the genetic sense). They earned more and spent more, and the economy grew. But because we had not made the necessary capital improvements in the prior decade, that spending increasingly was devoted to goods produced abroad. Japanese and German producers used a more advanced capital stock to turn out quality that was very appealing to these semi-affluent young adults.

Another interesting thing was happening as well. These folks were pushing back the traditional American calendar. They got married later in life (if at all) and had families later. They bought homes later. So the typical demographic progression was replaced by a consumption ethic that looked a great deal like the Twenties.

So where are we in the Nineties (stuck inside of Mobile with those Memphis blues again?) This decade will be little different from the past four. That huge population surge that occurred forty years ago will still shape the economy. Only now it is reaching what we once called middle age (let's say "chronologically gifted") and the generation that once dropped acid to escape reality is now dropping antacid to cope with it.

This suggests a somewhat better and more even economy than we are used to. As it ages, the postwar generation will pass through the peak of its productive powers and into its high saving years. This ought to bias the economy toward lower interest rates and consistent growth, allowing us to renew our capital stock and regain a strong competitive position in an interdependent world economy.

The real estate market will feel this transition as well. As they age, these households will adjust their housing consumption. The four bedroom, center hall colonial American Dream will be replaced in their affections by the high amenity, low maintenance, smaller unit that lies within easy reach of the golf course or the beach or the mountains or the museum.

As George Will put it, "In a democracy, demography is destiny." So it has been for the past four decades in the American economy, and so it shall be in the Nineties. And it looks like a decade of settling in. Ultimately, 1991 may be remembered by the postwar generation more as Cole Porter's centennial than Bob Dylan's fiftieth. And that would be because they've finally thrown off the gloomy concerns of the Sixties for a brighter view of their world. Ah, but they were so much older then; they're younger than that now.

Outlook for the Economy

Beneath the smoke and haze of recent economic statistics, the first tentative flames of recovery appear to be flickering. Existing home sales have increased for the fourth consecutive month, payroll employment increased in May, and construction spending was up, to name a few of the measures pointing toward recovery. Keeping a careful eye on the campfire is the Federal Reserve, who's concerned with stoking it too much but also mindful of the wet logs of tax increases, high consumer debt burdens, the commercial real estate slump, and the defense industry retrenchment. To feed the fire, the recovery needs healthy gains in personal income and employment. Will the flames spread, or will they burn themselves out?

Chances are that the recovery will spread. The statistics signal a recovery that is imminent, if it hasn't already arrived. After falling at an annual 2.6% rate in the year's first quarter, production in the U.S. economy, or real GNP, is expected to post a slight 0.2% increase in the second quarter. The rebound will gather steam during the second half of 1991, when growth is expected at a 2.3% clip. For the year, real GNP will fall 0.3%, down from 1990's modest 1.0% rate. Recovery will continue in 1992, with output growth of 3.0% expected.

Good News From The Labor Market

The strongest sign of recovery came from the release in early June of May's employment picture. Private payroll employment climbed by 49,000 workers, the first increase since last June (see chart). The gain was a relatively small one compared to the average increase tallied during the expansion of the 1980s, but it comes after an average decline of 242,000 workers over the previous four months. The unemployment rate, which is calculated from a survey that is separate from the payroll data, rose to 6.9% from 6.6% in April. Given the gain in payrolls, this increase is not alarming; since the labor force usually grows faster than the number of jobs early in recoveries, such jumps in the unemployment rate are common.

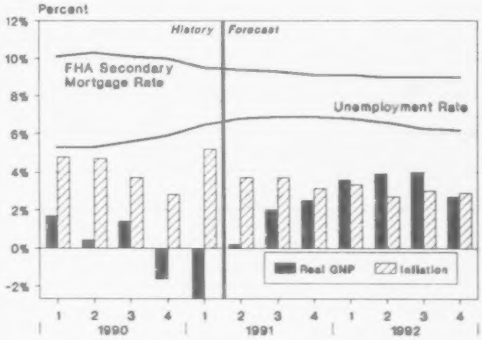
Other measures showing an advancing economy include the housing markets, discussed in depth on pages 4-7. The monthly index on industrial activity prepared by the National Association of Purchasing Management has increased for the fourth consecutive month, and the government's index of leading indicators has a three-month string of increases -- usually a sign of a waning recession.

On The Lookout for the Double Dip

Even if it is at hand, the recovery is far from robust at this stage. The recent spurt of activity may dissipate, with the economy heading back down in a "double dip." The failure of the economy to generate enough momentum to sustain a rebound is not uncommon, and even a positive rate of economic growth in the second quarter does not mean that we've put the recession behind us.

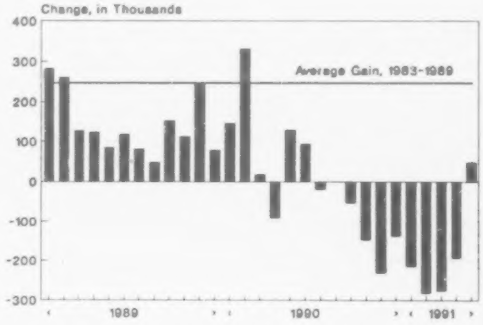
The incipient recovery could be choked off by higher interest rates, lower overseas demand, or some external shock such as higher oil prices or drought. Or the lack of consumer enthusiasm may snuff it out. The consumer spending chart shows gains in February and March, as prewar jitters were calmed by the overwhelming success in the

The Economic Outlook

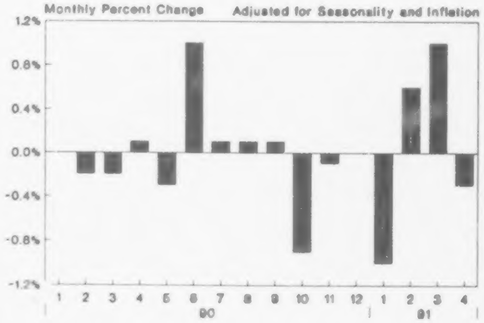


Employment Reverses Course...

First Gain in the Past 11 Months



...But Consumption May Not Be Back On Track



Gulf War. But April sported a decline, suggesting that the burst of spending from pent-up demand was over. May's results on spending are not yet available, but consumer confidence surveys taken during the month point to another dismal performance.

Another important factor that will keep the recovery subdued is an industry which will not be rescued by the tonic of lower interest rates. The defense industry is shrinking, and this movement from guns to butter is an important structural shift in the economy. While less spending on defense means that more resources can be channeled elsewhere in the economy -- a smaller federal deficit or more federal domestic spending, for example -- the transition will be painful for some companies and regions.

Fed Not Expected to Ease Further

With signs that the recovery is around the corner, the Fed is much less likely to ease monetary credit further. Short-term rates, which are heavily influenced by Fed credit moves, have already fallen over two percentage points since the beginning of the recession, as shown on the chart at right.

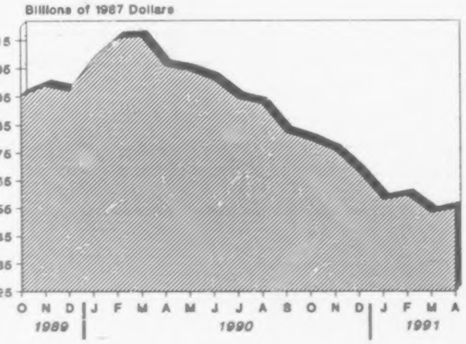
The Fed thinks it's done about as much as it can do. Since a change in credit policy takes several months to work its way through the economy, easing today could spur the economy late this year -- after we are well into a recovery. In other words, it's too late for extra credit stimulation now to end the recession. While it might provide insurance against another slump, the premium is high: additional inflationary pressure later. And fighting inflation remains the Fed's chief concern.

The graph also shows that long-term rates have been stubborn in falling. In fact, they've moved up in recent days. Lower long-term rates would insure a stronger recovery, but the Fed does not have the leverage to pull those down. Since these rates depend in large part on market expectations about inflation, and since we expect inflation to ease over the forecast horizon, there's room for these long-term rates to fall. Continued good news on inflation and a steady Fed hand on the monetary rudder will reverse the recent uptick in rates and go a long way to bringing us lower rates by year-end. Yields on the 30-year Treasury bond, which averaged 8.4% in the week ending June 7, are expected to fall to 8.0% during the third quarter.

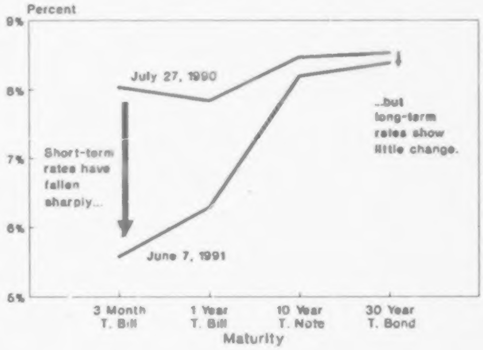
Recovery May Still Feel Like Recession

In many ways, determining the exact onset of the recession may be only an academic exercise since growth is expected to remain sluggish at least through 1991. Despite the relatively mild recession, the U.S. economy is slogging through an uncommonly long period of subpar economic growth, as seen at the chart at right. Since early 1988, the economy has not had even one quarter of growth that exceeded the average growth rate achieved during the 1983-89 period. A subdued recovery will continue this pattern through 1991, with growth only nearing average in 1992. Five years of mediocre performance is a weak foundation for growth in jobs, personal income, and housing, among other areas of the economy. In many ways, it may feel as though the recession is lingering.

Construction Spending May Have Hit Bottom

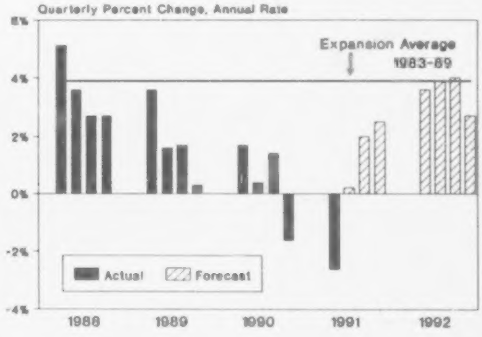


Movement in Short- and Long-Term Interest Rates



GNP's Sub-Par Performance

Below-Average Growth: Four Years and Counting



Housing Starts

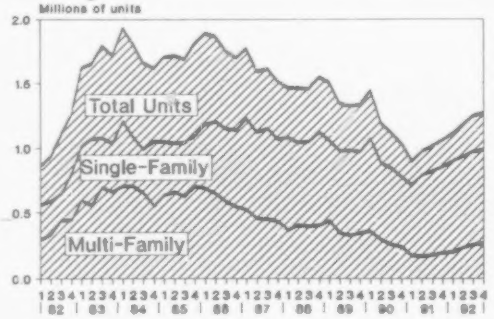
National Data

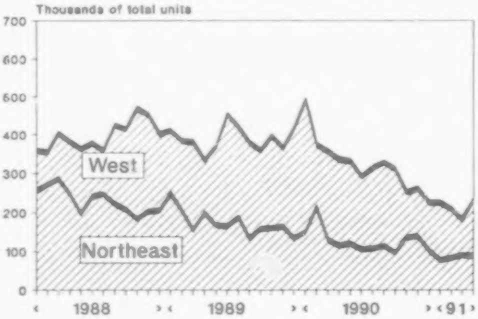
	Total	SF	MF:2-4	MF:5+
Apr 1990	1,217	901	51	265
Nov 1990	1,130	769	54	307
Dec 1990	971	751	17	203
Jan 1991	847	648	29	170
Feb 1991	992	788	37	167
Mar 1991	901	736	26	139
Apr 1991	***957***	***778***	***41***	***138***
Annual Averages:				
1989	1,381	1,005	56	320
1990	1,203	901	37	265
Percent Changes in April 1991 since:				
Apr 1990	-21.4	-13.7	-19.6	-47.9
Mar 1991	6.2	5.7	57.7	-0.7

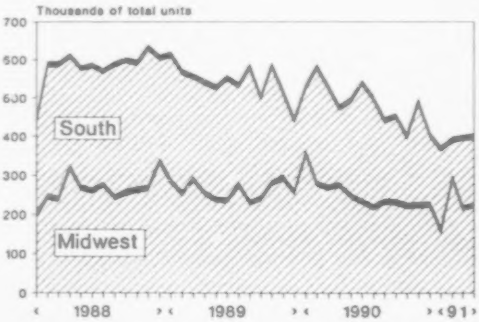
Regional Data

	Northeast	Midwest	South	West
Apr 1990	124	283	467	343
Nov 1990	147	232	483	268
Dec 1990	110	233	395	233
Jan 1991	86	167	361	233
Feb 1991	91	301	384	216
Mar 1991	98	224	389	190
Apr 1991	***96***	***231***	***392***	***238***
Annual Averages:				
1989	181	269	535	397
1990	135	259	478	330
Percent Changes in April 1991 since:				
Apr 1990	-22.6	-18.4	-16.1	-30.6
Mar 1991	-2.0	3.1	0.8	25.3

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







After retreating in March, housing starts increased in April by 6.2% to an annual rate of 957,000 units. This figure remains more than one-fifth below the April 1990 starts pace of 1,217,000 units. The increase was spread almost evenly between the construction of single and multifamily homes. Single-family housing starts increased to an annual rate of 778,000 units, which is 5.7% above the March figure of 736,000 units. The construction of multifamily homes was up from March by 8.5%, to an annual rate of 179,000 units.

The national gain was not well distributed among the four Census reporting regions. Accounting for over 85% of the total increase was the West region, where starts grew by 25.3% to 238,000 units. Despite the boost, the starts pace in the region remains off by almost one-third from its pace of a year ago. Construction also rose in the Midwest, where starts increased 3.1% from March to 231,000 units. Starts in the South edged up 0.8% to 392,000 units. In the Northeast, construction activity waned as starts slipped by 2.0% to an annual rate of 96,000 units.

With the approaching recovery, total housing starts in the second quarter will post a healthy 8.3% gain over the first quarter's rate. Lower mortgage rates and the belief that the end of the recession is at hand will boost construction by 76,000 units. By the third quarter of 1991, starts are expected to surpass the one million mark. In 1992, economic expansion and the easing of the credit crunch are expected to pull multifamily starts up by 30.6% and single-family starts up at a 19.1% clip. Overall, starts are expected to be 21.3% higher in 1992 than in 1991.

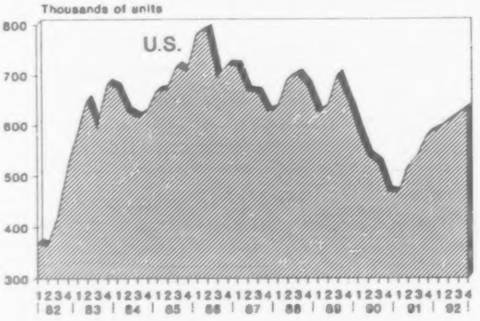
National Data

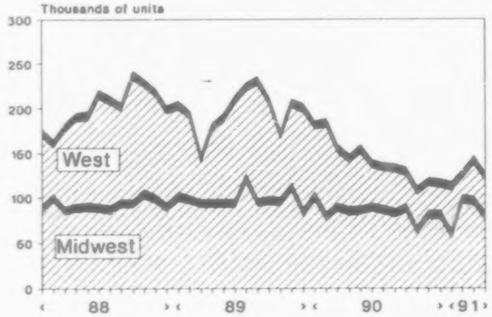
		Mo. Ago % Chg.	Yr. Ago % Chg.
Apr 1990	534	-4.5	-12.5
May 1990	535	0.2	-17.8
Jun 1990	549	2.6	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	414	-10.8	-34.0
Feb 1991	489	18.1	-19.3
Mar 1991	494	1.0	-11.6
Apr 1991	*500*	*1.2*	*-6.4*
Annual Averages:			
1989	654		-3.3
1990	534		-18.3

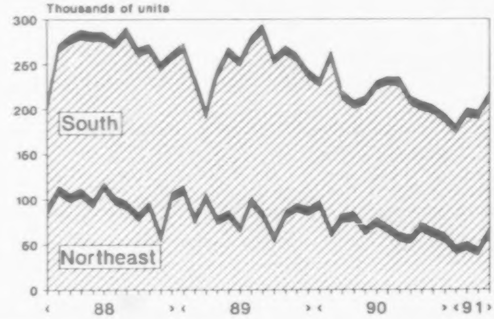
Regional Data

	Northeast	Midwest	South	West
Apr 1990	86	90	210	149
Nov 1990	68	86	205	122
Dec 1990	62	86	195	121
Jan 1991	49	65	183	118
Feb 1991	53	103	201	131
Mar 1991	47	101	199	147
Apr 1991	***69***	***84***	***219***	***128***
Annual Averages:				
1989	90	103	258	202
1990	75	90	222	147
Percent Changes in April 1991 since:				
Apr 1990	-19.8	-6.7	4.3	-14.1
Mar 1991	46.8	-16.8	10.1	-12.9

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







The Northeast region led the nation in the increase in the sales rate of new homes in April. The Northeast saw a dramatic 46.8% increase from March's dismal level of 47,000 units. Following the Northeast's lead, the South also recorded a healthy sales pace. There, sales increased 10.1%, driving the annual rate of sales up to 219,000 units. These sharp increases are in contrast to declines in the Midwest and the West. Sales in the Midwest fell 16.8%, dropping below the 100,000 mark to 84,000 units. The West's 12.9% decline put the annual rate at 128,000 units. The disparate regional performances collectively translate into a national increase of a modest 1.2%. After six consecutive months under the half-million mark, sales in April just reached that plateau. The April sales figure is 6.4% below the figure recorded in April of 1990.

The April figures support the view that January's poor performance will be the nation's low point. The ensuing recovery is reflected in the NAR forecast for new home sales. As early as the second quarter of 1991, new home sales are expected to be on the rise, gaining 53,000 units over the first quarter. By the fourth quarter of 1991, new home sales are expected to be 24.7% higher than the first quarter's rate. Overall, new home sales are expected to average 527,000 units in 1991, which is scarcely below 1990's rate of 533,000 units.

In 1992, sales are expected to grow at a healthy clip, leaving the year with a sales rate more than 16% greater than 1991's projected rate. Despite the growth, this sales rate of 612,000 new homes will be about 6% below 1989's level.

Existing Home Sales

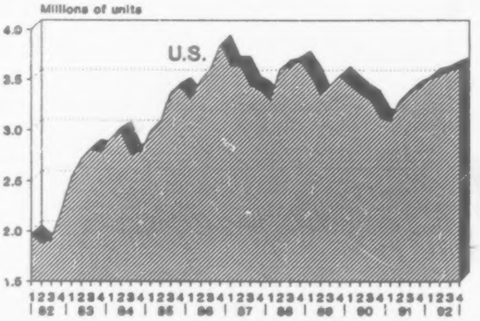
National Data

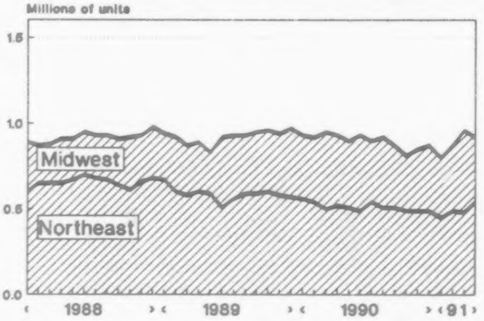
		Mo. Ago % Chg.	Yr. Ago % Chg.
Apr 1990	3,370	-2.0	-2.0
May 1990	3,350	-0.6	-2.0
Jun 1990	3,370	0.6	3.1
Jul 1990	3,320	-1.5	1.2
Aug 1990	3,410	2.7	-1.8
Sep 1990	3,160	-7.3	-0.9
Oct 1990	3,070	-2.8	-10.0
Nov 1990	3,150	2.6	-12.0
Dec 1990	3,130	-0.6	-11.5
Jan 1991	2,900	-7.3	-12.1
Feb 1991	3,160	9.0	-16.4
Mar 1991	3,220	1.9	-7.6
Apr 1991	***3,330***	***3.4***	***-6.4***
Annual Averages:			
1989	3,440		-4.3
1990	3,293		-4.3

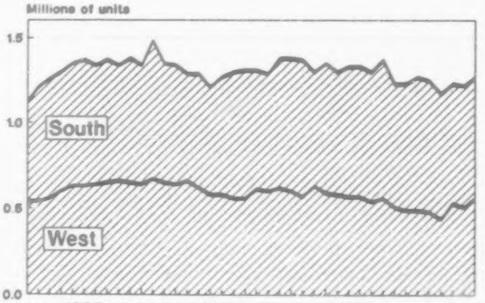
Regional Data

	Northeast	Midwest	South	West
Apr 1990	530	940	1,310	590
Nov 1990	500	860	1,280	500
Dec 1990	500	880	1,260	490
Jan 1991	460	810	1,180	450
Feb 1991	500	880	1,240	540
Mar 1991	490	970	1,230	520
Apr 1991	***550***	***930***	***1,280***	***570***
Annual Averages:				
1989	589	919	1,307	610
1990	517	896	1,310	569
Percent changes in April 1991 since:				
Apr 1990	3.8	-1.1	-2.3	-3.4
Mar 1991	12.2	-4.1	4.1	9.6

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors®, 'Home Sales'







The rate of existing home sales increased for the third consecutive month and reached its highest level since last August. Following increases of 9.0% in February and 1.9% in March, sales of existing homes climbed another 3.4% in April. Consequently, sales have recovered almost 15% from its low point in January 1991. The annual resale rate for April stands at 3.33 million units and is 6.4% below the figure recorded in April of 1990.

Only the Midwest failed to post a gain in resales during April. In the Northeast, sales of existing homes displayed the greatest strength, increasing a healthy 12.2% from March's 490,000-unit rate. One tentative sign of economic recovery in the Northeast is that the rate of 550,000 units was more than 5% greater than the average sales rate in the region during 1990. The rate increased 9.6% in the West, totalling 570,000 units, while in the South, sales gained 4.1% to an annual rate of 1.28 million units. The rate of existing home sales dropped 4.1% to an annual rate of 930,000 units in the Midwest.

According to the NAR forecast, existing home sales are expected to increase 6.4% between the first and second quarters of 1991. Thereafter, sales are expected to continue to grow at a healthy clip, reaching an annual rate of 3.43 million units by the fourth quarter of 1991. As economic recovery takes hold, existing home sales will be positioned for robust growth. In 1992, sales are projected to increase 8.1% to 3.57 million units. Sales will continue to increase in 1993, but will experience a slight deceleration, increasing a modest 3.1% to 3.68 million units.

Prices of New & Existing Homes

National Data

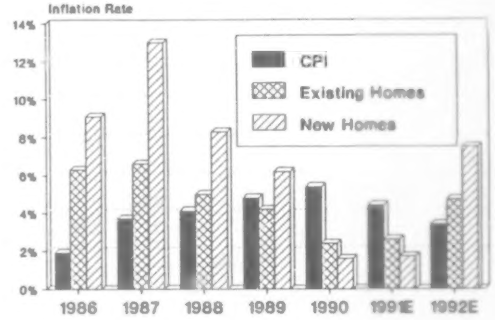
	Median		Average	
	Existing	New	Existing	New
Apr 1990	95,700	130,000	117,900	153,400
Nov 1990	92,000	118,900	115,600	144,800
Dec 1990	91,700	127,000	114,100	153,400
Jan 1991	95,600	117,900	123,000	148,600
Feb 1991	94,000	120,000	119,700	148,900
Mar 1991	98,200	123,300	125,200	157,700
Apr 1991	***100,200***	***122,000***	***128,400***	***155,400***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in April 1991 since:				
Apr 1990	4.7	-6.2	8.9	1.3
Mar 1991	2.0	-1.1	2.6	-1.5

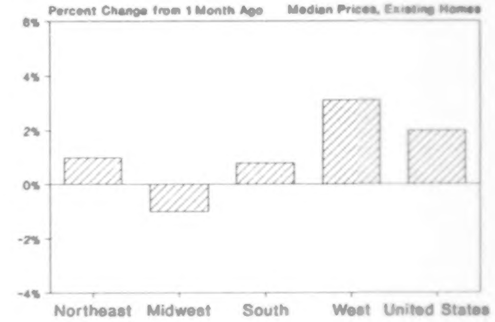
Regional Data

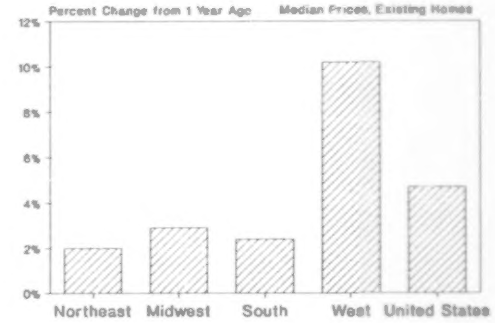
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Apr 1990	141,300	75,200	85,900	137,800
Nov 1990	134,200	71,800	83,500	139,600
Dec 1990	134,400	72,300	82,800	131,400
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	***144,100***	***77,400***	***88,000***	***151,800***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in April 1991 since:				
Apr 1990	2.0	2.9	2.4	10.2
Mar 1991	1.0	-1.0	0.8	3.1

Levels are shown in dollars.
Source: National Association of Realtors®, 'Home Sales'







The national median price of existing single-family homes topped the $100,000 level for the first time in April. The month's $2,000 increase put the price at $100,200, 4.7% above the median price of a year ago. It was only the fourth increase recorded in the past twelve months, but the third gain in the last four.

In the market for new homes, the median price declined 1.1% to $122,000 in April. The median price of a new home is 6.2% below the figure of a year ago, but the recent trend in the price is not very clear. It has fallen in seven of the past twelve months, ranging from a low of $113,000 to a high of $127,000.

The average price of an existing home increased by 2.6% in April to $128,400. Since April of 1990, the average price has risen 8.9%. A decline of 1.5% in April resulted in a loss of $2,300 to the average price of a new single-family home.

Modest appreciation in the median price of an existing single-family home is expected over the next year, with an overall increase of 2.6% in 1991. Prices are expected to firm in 1992 and should increase 4.7% in 1992. The price appreciation of a new single-family home is projected to modestly accelerate in 1991, with prices increasing only 1.7% in 1991. In 1992, however, the median price of a new single-family home is expected to appreciate with renewed force, increasing 7.5% to $133,600.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

Charting the RTC's Progress:

Impacts On Real Estate Markets

Introduction: The insolvency of many of the nation's savings and loan associations presented Congress with a Gordian knot. The industry became entangled as a result of the changing economic environment throughout the last few decades. The high inflation of the Seventies, high interest rates, changes in government regulation, and oil booms and busts in the southwestern United States culminated in the current crisis. The most daunting task in restoring financial stability to the industry is liquidating failed thrifts' assets, particularly the vast amount of real estate properties.

To resolve insolvent thrifts, Congress created the Resolution Trust Corporation (RTC) in August, 1989. The purpose of this progress report is to review the performance of the RTC, while paying particular attention to issues surrounding real estate markets. A summary of the events leading up to the savings and loan crisis and the government's policy solution to the crisis will set the stage for review. Two measures of performance are considered in this progress report. A measure of the RTC's results to date, including a description of the asset portfolio and a detailed break out of sales, is presented first. Another measure, which is perhaps more telling, examines the obstacles encountered by the RTC in selling real estate and their strategies to overcome them. Also considered is the economic impact of a large number of property sales over a short span of time within a local market, known as *dumping*. Our analysis will then take a slightly different turn and consider the RTC's provisions for affordable housing. We will conclude with a brief discussion of working with the RTC.

Historical Perspective: The savings and loan industry was created during the 1930s to service the home mortgage market. Up until 1980, savings and loan associations dealt almost exclusively in residential mortgage lending. For the most part, this provided a safe and comfortable existence. There were, however, two weak links in the accounting structure. First, thrifts were making long-term, fixed-interest-rate mortgage loans, and funding these with short-term liabilities -- typically, passbook deposits that could be withdrawn on demand. Second, deposits were uniformly insured by the Federal Savings and Loan Insurance Corporation (FSLIC), which used regulatory oversight, not risk-based premiums, to discourage risky investments.

This arrangement lasted only as long as interest rates and inflation remained low and thrift failures were few. By the late-1970s, the first weak link frayed when interest rates jumped due to increasing inflation. Since thrifts were limited in their ability to raise interest rates to attract deposits, funds flowed to other interest-bearing assets, such as money market mutual funds. As a result, losses in the thrift industry became excessive.

To shore up these losses, the government loosened regulations and created incentives for thrifts to diversify away from residential mortgage lending. However, many of these investment opportunities were risky and, combined with loosened government regulation, exacerbated the problems created by rising interest rates. By the late 1980s, weaker economic performance and falling real estate values exposed the poor quality of many of these loans. As a result, many thrifts became insolvent, forcing the FSLIC to honor the thrifts' obligations to depositors. Inadequate FSLIC reserves required the U.S. taxpayer to make up the difference.

Government Response: Longstanding problems in the savings and loan industry combined with the insolvency of the FSLIC demanded that the federal government take direct action. Congress responded with the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) on August 9, 1989. FIRREA provided for a major reorganization of the federal regulatory agencies which oversee the savings and loan industry. Both the FSLIC and the Federal Home Loan Bank Board (FHLBB) were replaced with the newly created Office of Thrift Supervision (OTS) and the RTC. The OTS has supervisory and regulatory authority over savings and loan associations, and governs the operation of the RTC.

The RTC has control over all FSLIC-insured thrifts which have become, or will become, insolvent between January 1, 1989 and August 9, 1992. When an institution is determined to be insolvent, it is designated as either a conservatorship or receivership institution.

A conservatorship institution is managed by an RTC-appointed conservator. A conservator works, on a day-to-day basis, with the owners and managers of the insolvent thrift to restore its financial stability. In so doing, the RTC will often require a conservatorship institution to liquidate some of its assets. In the case of a conservatorship, thrift owners and managers maintain an active role in the day-to-day operation of the insolvent thrift, including the liquidation of some of the thrift's assets.

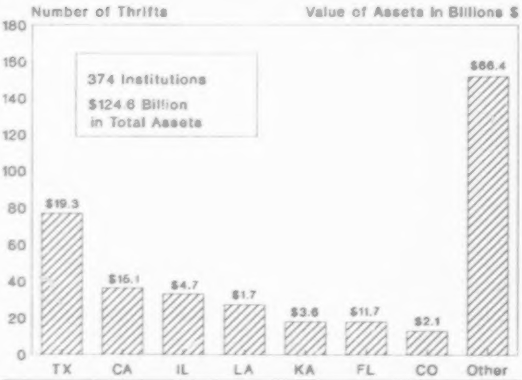
When the RTC determines that financial stability cannot be restored to an insolvent thrift, whether it has been under conservatorship or is a newly acquired thrift, it is placed under the RTC's receivership program. Unlike a conservatorship, a receivership is placed under the complete control of the RTC. A receivership institution is closed to the general public, and is no longer able to accept new deposits or make new loans. The RTC's goal is to liquidate all assets, going so far as to auction the computers and furnishings of the receivership institution. Thrift owners and managers neither play a role in the day-to-day operation of the thrift, nor do they assist in the sale of assets. The assets of a receivership are sold directly by the RTC.

Results to Date: As of March 31, 1991, the RTC has disposed of $148 billion in assets from 578 insolvent thrifts. The RTC has sold $70.1 billion in securities, $55.1 billion in mortgages, $12.1 billion in nonmortgage loans, $4.4 billion in real estate, and $5.8 billion in other assets.

Of the thrifts under RTC control, 204 are conservatorship institutions. The remaining 374 are receivership institutions which have been closed by the RTC. More than half of the closed thrifts were located in Texas, California, Illinois, Louisiana, Florida, and Kansas. In resolving the 374 receivership institutions, 194 were purchase and assumption transactions (P&As). Using this approach, the RTC sold all deposits, selected liabilities, and a portion of the assets to acquirers. An additional 128 cases were insured deposit transfers (IDTs), whereby acquiring institutions established accounts for the depositors of failed institutions and acquired some of the failed thrifts' assets. The remaining 52 cases were insured deposit payouts (POs) in which the RTC directly paid depositors their insured deposits and retained all of the assets from the failed thrifts.

Geographic Distribution of Receiverships

Value of Assets at Time of Closure

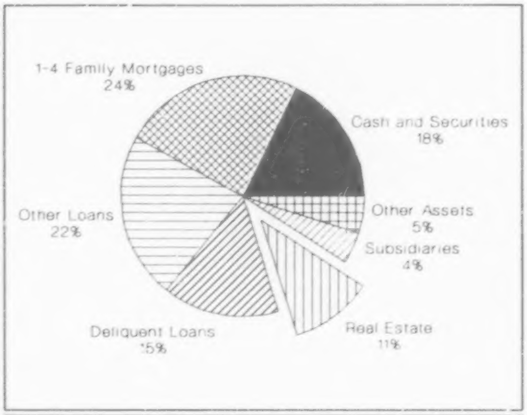


The RTC holds an additional $161.9 billion in assets that it hopes to sell off. Of this total, the RTC has retained $69.3 billion in assets from the 374 receivership institutions, and $92.6 billion in assets from the 204 institutions under conservatorship. The assets under RTC control include 45,172 commercial, residential and recreational properties.

Portfolio Description: A significant portion of the thrift assets under RTC control are relatively liquid, performing assets such as single-family mortgage portfolios and other loans and government securities. Typically, these assets are transferred or sold to other financial institutions together with the transfer or sale of the

The RTC's Portfolio of Assets

Percentage of Total Dollar Value



institutions' franchises and their deposits. The RTC also must dispose of a continually growing number of non-performing assets. Most non-performing assets are real estate properties, such as residential homes, hotels, office buildings, shopping centers, and undeveloped land. Because they were either abandoned before completion or have remained vacant since foreclosure and have deteriorated, many of the non-performing real estate properties are of inferior quality. The purchase of these properties requires a buyer to have the resources to make a downpayment on the property and to invest 10% to 20% of the property value to bring it up to acceptable condition.

Seller Financing: The sale of commercial real estate and bulk residential property has also been hampered by a lack of sufficiently available third-party financing. The RTC believes that the sale of much of its land and commercial real estate property can be facilitated by providing financing itself.

In financing a sale, the RTC provides the purchaser with a loan in the amount necessary to consummate the sale of the property. In the fashion of the well established secondary market for residential mortgages, the RTC plans to work with the secondary market to securitize commercial loans for resale to private investors. This requires that the terms of the loan be written to suit the secondary market.

Up until recently, the RTC had a small scale seller-financing plan which did not adequately meet the demand for seller-financed sales. Seller financing was previously available only for real estate and mortgage sales, with a total $1.25 billion limit. In early December, 1990, the RTC Oversight Board approved a revised seller-financing plan. Seller financing was expanded to include real estate assets, non-performing loans, and high yield securities, with a total $7.0 billion limit. This limitation applies to all loans originated by the RTC which are outstanding. Of this amount, a minimum of $250 million has been allocated for the RTC's Affordable Housing Disposition Program.

Seller financing is available for transactions whose sales price equals or is in excess of $500,000. This minimum transaction price reflects the value of the RTC's inventory of commercial real estate properties, many of which are valued above $500,000. The policy applies uniformly to all illiquid assets. Assets are deemed illiquid based on two criteria: First, due to a lack of available commercial funding on acceptable terms, the RTC determines that an asset isn't readily marketable. Second, the RTC determines that competitive marketing of the asset has already occurred and that a seller financed sale will bring a greater return than other alternatives such as a cash sale, securitization, or a deferral of the sale.

The RTC prefers a down payment of 25%, but will consider down payments as low as 15% of the sales price. On a case-by-case basis, the RTC will consider allocating a 15% commitment between a down payment and a funded escrow to be used for capital improvements on the property. Because of the poor quality of many of the RTC's properties, below-market financing may often be requested, but the RTC's policy is to set interest rates which equal prevailing mortgage rates. The sale of single and multifamily properties under the Affordable Housing Disposition Program has a separate set of guidelines, which will be outlined later.

Auctions: A second strategy adopted by the RTC in returning real estate assets in a timely manner to the private sector is auctioning. Since many properties are offered up for sale at one time, auctions can provide for the rapid disposition of the RTC's inventory of real estate assets. There is, however, a potential downside to the auctioning process. Unloading many properties at once onto a local market at below-market prices may lower the overall value of real estate in a particular market. The RTC has been advised by in-house and outside experts to consider local economic conditions when planning an auction.

While auctioning has proven to be an effective mechanism for the rapid sale of real estate assets, the RTC's first attempt at an auction was canceled. The highly publicized National Satellite Auction was scheduled to take place in November of 1990. It is believed that the auctioning firm selected by the RTC was not prepared to conduct an auction which was so large in scope. The plan was to offer-up for auction nearly $300 million in assets, while bidding was conducted simultaneously on three continents, via satellite.

Even if the auction had occurred, the prospects for success were limited. The bulk of assets for sale were hard-to-sell commercial real estate properties, including hotels and office towers in glutted markets and empty shopping centers. In the typical sales process, investors allocate substantial time and financial resources to evaluate investment properties only after a conditional sales contract has been secured. Because these properties were low grade to begin with, and there are no conditional sales contracts at an auction, per se, prospective investors would have been presented with an unusually risky investment proposition. The likelihood of closing a sale would have been made even more tenuous by the uncertainty in securing financing for commercial real estate properties.

While the obstacles encountered in planning the National Satellite Auction suggest that auctions may be more effective in the sale of specific types of properties within a local market, the RTC is carefully planning a second commercial real estate auction. In an effort to clear its books of residential properties valued at under $100,000, the RTC is planning a series of 80 to 90 auctions in various cities throughout the nation over the next six months. These auctions are being managed by local auctioneers who, the RTC believes, are highly skilled at selling and have a good feel for property values and assets in their own markets.

Auctioned assets will be offered on a no-reserve absolute basis, that is with no minimum price, as long as the real estate is valued at less than $100,000 and the property has been widely exposed in the market. The RTC believes that the quick disposition of these small assets will maximize returns by freeing up staff to concentrate on large sales.

The RTC successfully carried out its first big residential auction in Phoenix, Arizona shortly after the failure of the first scheduled auction. Asking prices were roughly 20% below the price original owners or builders paid to buy or build the homes. On average, properties were sold for 78% of the asking price. These prices were comparable to those being paid for residential properties in many private auctions. Since market-level prices were achieved in Phoenix, the RTC is hoping to allay the fear that the RTC would drive real estate values down by selling too low in auction. This auction has been marked as a forward step in disposing of the RTC's large portfolio of residential real estate properties.

Liberalized Pricing Policy: The RTC has recently adopted a new, flexible pricing policy which will allow it to quickly adjust prices in response to local market conditions. Local brokers heavily criticized the RTC's original appraisal system, because they believed prices did not reflect local market conditions, and the system limited their ability to adjust prices to these conditions. Formerly, real estate prices could be reduced by only 20% of the initial appraisal value if a sale did not occur after nine months. As a result, offers lower than 80% of appraised value could not be accepted until a new appraisal was ordered, supporting the lower price. Under the new policy, the RTC does not have to incur the expense of ordering a new appraisal or delay acceptance of an offer until a new appraisal is completed. The RTC will continue to rely on appraisals, but will authorize write-downs from appraisals of up to 20% immediately, 40% after 6 months and 50% after 18 months. The new policy will provide local agents with increased discretion to negotiate discounts.

Portfolio Sales: The RTC has developed a new strategy to sell approximately $100 billion of assets, many of which are commercial properties, for which there is no ready market. The RTC is prepared to negotiate the sale of office buildings, warehouses, golf courses and marinas, in packages valued at $100 million or more. These packages will be offered in two forms, either as pools having similar characteristics, such as a collection of hotel properties, or a collection of diverse assets. In marketing the former, the RTC will advertise the characteristics of the pool, and, based on investor response, select the best proposal and negotiate a final sale. Under the latter approach, the RTC will construct a pool of assets, and solicit offers for that specific portfolio. In some instances, discounted prices will be offered to buyers who agree to provide payments to the RTC from the earnings of the assets for a negotiated period of time. Because there is a limited field of purchasers for such large sales, the RTC is identifying only those investors who can and would have an interest in buying large amounts of property.

The properties selected for these portfolios have been marketed individually for six months and have not sold. L. William Seidman, Chairman of the RTC, refers to the current pricing policy toward hard-to-sell assets as a "Filene's Basement" approach, that is the price continues to fall until it attracts a buyer. Thus the price tag on a portfolio is equal to the sum of the discounted prices on the assets contained in the portfolio.

To help facilitate portfolio sales, the RTC is offering seller financing to those who qualify. While the RTC is willing to entertain proposals to group houses, condos or small commercial buildings together in bulk sales, its main market strategy remains to sell these properties individually.

Local Economic Impact: Concerns have been raised that the RTC's disposal of properties could harm local markets. It's argued that a quick sell-off of properties could depress prices in local markets, not only hurting private owners trying to sell competing properties, but also reducing the value of otherwise healthy thrifts' portfolios to the point that they, too, become sucked into insolvency. This, of course, would only contribute to the problem by requiring more taxpayer assistance in meeting depositors' claims and adding more properties for the RTC to sell.

Yet there are reasons to believe that, in most cases, the impact on local markets will be minimal, especially in the single-family mortgage market. The overriding reason is that, while the amount of property the RTC has to sell is enormous, it's minute in comparison to the nation's housing stock and generally manageable relative to the local market. Additionally, the sales will not transpire overnight, but over a period of a few years. There are areas of the country, however, where a quick sell-off may not be a good idea, particularly in the six states which account for over 80% of the RTC's property holdings: Colorado, Oklahoma, Texas, Louisiana, Arizona and Florida. An empirical study by Vandell and Riddiough suggests that the RTC should remain cautious about selling single-family housing in local markets that show few signs of recovery in housing activity and prices. For markets with a housing sector already on the rebound, an approach that's too cautious may be a detriment to the necessary pricing adjustments in the housing markets. This would prolong the uncertainty in the market, making the adjustment process more difficult and perhaps lead to greater default rates in the long run.

The authors also warn that selling a concentration of single-family homes at low prices or with subsidized financing, while advancing the affordability goals of the RTC, may cause further disruption in the affected neighborhood. The lower housing values may lead current families to perceive a loss of value in their homes, perhaps leading some homeowners to move to other areas.

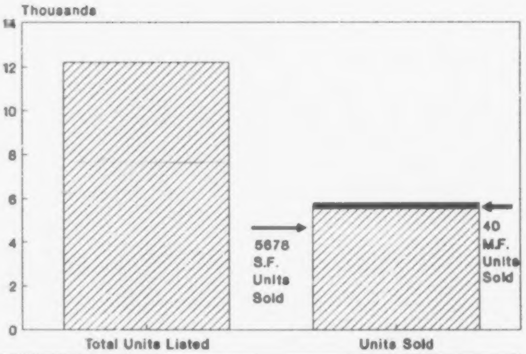
Because of the investment nature of the industry, the impact on commercial property is less difficult to assess, according to Vandell and Riddiough's analysis. Unlike the RTC's single-family holdings, which tend to be concentrated in new suburban developments, most of the RTC's commercial properties are scattered about metro areas. Since the construction of these buildings led to the thrifts' difficulties, many are presumably ill-conceived. Consequently, the authors argue that there should be little impact on the investment grade market. Additionally, prices may not go much lower since the oversupply problem is already reflected in the current prices. To support their conclusions, Vandell and Riddiough point to the Dallas properties liquidated by the FSLIC in the late 1980s which sold at 120% to 130% of their appraised value (although admittedly the appraisals may have been conservative). Abrupt price changes, or price shocks, usually are the result of an unanticipated event; the sale of the RTC's properties is hardly unexpected. What may cause problems is how quickly the properties are sold if the market incorrectly anticipates how low the prices of some buildings will have to go before they sell. In this case, time will be required for the market to reassess the values of the area's commercial properties.

Affordable Housing: To provide homeownership and rental opportunities for low-income individuals, the RTC has established the Affordable Housing Disposition Program. The program provides low-income individuals with the opportunity to purchase properties which meet certain appraisal criteria before they are available to the general public. Properties in the following price ranges are offered exclusively to low-income individuals for a period of 90 days: single-family residences appraised at $67,500 or less; $76,000 for a duplex; $92,000 for a triplex; and $107,000 for a fourplex. These properties are offered to buyers who have an adjusted income which is less than 115% of the area median income and who intend to occupy the house as their principal residence. The RTC also offers these properties to public agencies and nonprofit organizations who either agree to resell the units to lower-income individuals (families and individuals whose incomes do not exceed 80% of area median income) or provide rental housing which is affordable to lower-income individuals for the remaining useful life of the property. If a qualified nonprofit, public agency or low-income family does not make an offer within the 90-day period, then the RTC may sell the property to any qualified purchaser.

The RTC has also provided for the sale of multifamily properties which meet specific criteria under the Affordable Housing Disposition Program. Multifamily properties which are eligible for the program contain more than four dwelling units which have appraisal values not exceeding: $29,500 for an efficiency; $33,816 for a one-bedroom unit; $41,120 for a two-bedroom unit; $52,195 for a three-bedroom unit, and $58,392 for a unit containing four or more bedrooms. For the first 90 days, multifamily properties will be sold exclusively to buyers who agree to make at least 20% of the units available to very low-income families (families and individuals whose incomes do not exceed 50% of area median income) during the remaining useful life of the property. Additionally, at least 35% of the units must be available to lower-income families (families and individuals whose incomes do not exceed 80% of area median income). If the 90-day period has elapsed without an offer from a qualified purchaser, the RTC may sell the property to any qualified purchaser without these restrictions.

The Progress of Affordable Housing Sales

Holdings and Sales



Prospective buyers and properties which qualify for the Affordable Housing Disposition Program but are believed to be ineligible for private sector financing may utilize the RTC's seller-financing program. Under the RTC's Affordable Housing Seller-Financing Program, the terms of financing are more relaxed than conventional loan programs. For example, the downpayment required for the transaction will not, in many instances, exceed 5% of the purchase price. To ease the costs associated with the sales transaction, the RTC will often pay all or part of the closing costs. Of the $7.0 billion allocated for seller financing in early December 1990, the amount of $250 million has been reserved for affordable housing.

The ~~RTC is also~~ offering properties at no charge to municipal housing agencies and nonprofit housing groups. These properties must either have an appraised value under $5,000 or be deemed to have less value than what it would cost to maintain them while they are in the hands of the federal government. Those properties that don't sell or that cost more to manage than they are worth will be given away. An expected 2,000 to 3,000 will be donated to states or nonprofit organizations.

Working with the RTC: The RTC is drawing upon the expertise and services of the private sector in liquidating the assets of failed thrifts. Among the many types of services employed by the RTC, there are countless opportunities for real estate brokerage and appraisal firms.

The first step for any broker who wishes to sell RTC-owned assets is to contact the nearest RTC regional office and to register with the RTC's Asset Contracting Division. All interested brokers must complete the Contractor Registration questionnaire. The RTC will only contract with brokers possessing all of the licenses necessary to sell real estate. Of particular interest to the RTC are those brokers who have demonstrated an expertise in the marketing and sale of real estate assets in the geographic area in which they plan to sell RTC-owned assets. Commission fees are negotiated at the time the asset is listed with the broker. An asset's complexity, location, and marketability are the three primary factors considered in determining commissions.

While there exist many opportunities for real estate practitioners, the bureaucratic nature of the agency has proven to be a hindrance for many private sector contractors wishing to work with the RTC. For example, many real estate brokers are discouraged by the RTC's sales contracts, which are complex and contain no variation for local laws. To address this concern, the RTC is currently reviewing all contracts to ensure that they are comprehendible and conform to standard local practice. Secondly, many brokers believe that the RTC's appraisal of property values does not reflect local market conditions, particularly for commercial real estate properties. In an effort to reform its appraisal mechanism, the RTC has liberalized its pricing policy, relying on the discretion of local experts in determining real estate property values. Finally, the RTC has been criticized for its inability to provide timely, accurate and complete information on assets. The RTC is currently preparing an on-line, real estate information system in response to these problems.

Several local Realtor® associations have initiated programs designed to help their members work effectively with the RTC. The Houston Association of Realtors® recently introduced an RTC helpline for its members. The helpline feeds directly into the RTC's Gulf Coast Sales Center and provides Realtors® with fast answers to specific questions about RTC procedures and properties. To facilitate the exchange of ideas between association members and RTC officials, the association has planned several luncheon meetings. The association has also arranged an agreement with the RTC whereby all RTC-held commercial properties are listed on the local Commercial Multiple Listing Service.

The Dallas Association of Realtors® has also established a helpline to provide general information on how to work with the RTC. The association also sponsors joint seminars with the RTC. These seminars provide information on working with the RTC, with some focusing specifically on the needs of real estate practitioners who specialize in commercial and investment real estate.

To receive additional information on working with the RTC, contact: Fannie White, Government Relations Division, National Association of Realtors®, (202) 383-1093 and request a copy of *How To Do Business with the Resolution Trust Corporation.*

by Kimberly A. Martin
Research Economist
Forecasting & Policy Analysis

References

Bowsher, Charles A. "Resolution Trust Corporation: Performance Assessment to Date." U.S. General Accounting Office. February 20, 1991.

Brady, Nicholas F. "Statement on Behalf of the Oversight Board of the Resolution Trust Corporation Before the House Committee on Banking, Finance, and Urban Affairs." Oversight Board, Resolution Trust Corporation. Washington, D.C. June 14, 1990.

Bureau of National Affairs, Inc. "RTC Adopts Policy Statement on Bulk Sales To Provide Flexibility For Large Investors." *BNA's Banking Report*. May 27, 1991.

Bureau of National Affairs, Inc. "RTC To Begin Using Local Auctioneers To Sell Smaller Assets, Hasten Sales" *BNA's Banking Report*. May 20, 1991.

Carlton, Jim. "At RTC's First Big Auction of Homes, Properties Go for 78% of Asking Price." in *The Wall Street Journal*. November 19, 1990.

Dodge, Robert (contact). "RTC Seller Financing Guidelines." Resolution Trust Corporation. Washington, D.C. February 11, 1991.

Federal Information Systems Corporation; Federal News Services. "Media Briefing on Resolution Trust Corporation." RTC News Briefing. May 16, 1991.

Federal Information Systems Corporation; Federal News Service. "Open Meeting of the Oversight Board of the Resolution Trust Corporation." May 15, 1991.

Geurds, Pamela. "RTC Hotlines." in *Realtor News*. May 27, 1991.

Goldman Sachs. "Financial Market Perspectives." *Economic Research*. June, 1990.

Mason, Todd. "Real Estate Industry Hisses At RTC Property Auction." in *The Wall Street Journal*. September 12, 1990.

Monroe, Peter H. President, Oversight Board For the RTC. "Make an Investment in the RTC." Remarks before the Urban Land Institute. Washington, D.C. March 1, 1991.

National Association of Realtors. "Government News; RTC Watch." in *Realtor News*. December 10, 1990.

National Association of Realtors, Real Estate Finance Division. "Seller Financing and the Disposition of RTC Properties." Washington, D.C.

Newsletter Division of *American Banker*. "The RTC Watch." Bethesda, Maryland. October 12, 1990 - Present.

Resolution Trust Corporation, Assets and Real Estate Management Division. "How To Buy Real Estate: Answers To the Most Frequently Asked Questions." Washington, D.C. April, 1990.

Resolution Trust Corporation; News Release. "RTC To Initiate Auctions To Sell Inexpensive Assets Nationwide." Office of Corporate Communications. PR-528-90. October 18, 1990.

Resolution Trust Corporation. *RTC Review*. Washington D.C. Vol. II. January 1991 - Present.

Saft, Stuart M. "The Basics of FIRREA and the Resolution Trust Corporation." *The Real Estate Journal*. Winter, 1990.

Schmidt, Susan. "Agency Prepared to Deal On Thrifts, Real Estate; RTC Plans Deep Discounts to Sell Inventory." in *The Washington Post*, Section A. March 26, 1991.

Siddon, Art and Felisa Neuringer (contacts). "Oversight Board Revises Seller Financing Property." Resolution Trust Corporation. Washington, D.C. December 7, 1990.

Sumichrast, Michael. "RTC Cranks Up Effort To Dispose of Assets." *Real Estate Perspectives*. January 15, 1991.

Thompson Publishing Group, Inc. "Guide To Contracting With the RTC: Introduction and Overview." July, 1990.

Vandell, Kerry and Riddiough, Timothy. "The Impact of RTC Dispositions on Local Housing and Real Estate Markets." *Housing Policy Debate*. Office of Housing Policy Research, Fannie Mae, Washington, D.C. Volume 2, Issue 1.

Warren, Gorham and Lamont. "RTC Oversight Board Approves $7 Billion in Seller Financing." *Housing and Development Reporter*. 1990.

White, Lawrence J. "The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation." Oxford University Press. New York. February, 1991.

Zax, Leonard A. and Robert H. Ledig. "The RTC and the Real Estate Industry." in *The Real Estate Finance Journal*. Fall, 1990.

Source for All Charts: "The RTC Review." Resolution Trust Corporation. March 31, 1991.

U.S. Economic Outlook: June 1991

	90.4	91.1	91.2	91.3	91.4	92.1	92.2	92.3	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-1.6	-2.6	0.2	2.0	2.5	3.6	3.9	4.0	2.5	1.0	-0.3	3.0	2.7
Industrial Production	-7.2	-9.6	-0.2	1.1	3.1	4.4	6.2	7.2	2.6	1.0	-2.8	4.2	4.9
Civilian Employment	-0.9	-2.4	1.1	1.2	1.0	1.5	1.7	2.0	2.0	0.5	-0.5	1.5	1.5
GNP Inflation Index	2.8	5.2	3.7	3.7	3.1	3.3	2.7	3.0	4.1	4.1	3.9	3.2	3.1
Consumer Prices	7.0	3.5	2.5	3.3	3.6	3.4	3.3	3.9	4.8	5.4	4.4	3.4	3.6
Value of the U.S. Dollar	-19.0	8.0	38.4	4.4	3.5	2.5	1.7	1.2	6.2	-9.6	1.8	4.4	-0.6
Percent													
Mfg. Capacity Utilization	80.8	78.0	77.5	77.4	77.7	78.3	79.3	80.5	84.0	82.3	77.7	79.9	82.8
Civilian Unemployment	5.9	6.5	6.8	6.9	6.9	6.8	6.6	6.3	5.3	5.5	6.8	6.5	6.0
Percent of GNP													
Federal Tax Receipts	20.4	20.5	20.5	20.5	20.5	20.7	20.7	20.7	20.2	20.3	20.5	20.7	20.7
Federal Expenditures	23.7	22.6	22.9	23.7	24.0	24.1	23.9	23.6	22.8	23.3	23.3	23.8	23.2
Federal Budget Deficit	-3.3	-2.1	-2.4	-3.2	-3.4	-3.5	-3.2	-3.0	-2.6	-3.0	-2.8	-3.1	-2.6
Interest Rates, Percent													
Federal Funds Rate	7.7	6.4	5.8	5.9	5.9	5.9	6.1	6.4	9.2	8.1	6.0	6.3	6.8
3-Month T-Bill Rate	7.0	6.0	5.5	5.5	5.7	5.7	5.8	6.1	8.1	7.5	5.7	6.0	8.2
Prime Rate	10.0	9.2	8.7	8.5	8.5	8.6	8.8	8.8	10.9	10.0	8.7	8.7	8.8
Discount Rate	6.9	6.2	5.7	5.5	5.5	5.5	5.7	5.8	6.9	7.0	5.7	5.7	6.1
Corporate AAA Bond Yield	9.3	8.9	8.8	8.6	8.5	8.5	8.6	8.7	9.3	9.3	8.7	8.6	8.6
30-Year Government Bond Yield	8.5	8.2	8.3	8.0	8.0	8.0	8.1	8.2	8.4	8.6	8.1	8.1	8.2
Mortgage Rates, Percent													
30-Year Fixed Rate	10.0	9.5	9.4	9.3	9.1	9.1	9.0	9.0	10.3	10.1	9.3	9.0	8.9
1-Year Adjustable	8.1	7.6	7.2	7.1	7.0	7.0	7.0	7.0	9.3	8.4	7.2	7.0	7.0
Home Sales & Starts													
Thousands													
Total Single-Family Sales*	3,879	3,796	4,069	4,196	4,271	4,399	4 459	4,548	4,442	4,179	4,083	4,501	4,661
Existing Single-Family Sales	3,117	3,093	3,290	3,383	3,429	3,51[illegible]	[illegible]	3,590	3,467	3,305	3,299	3,567	3,677
New Single-Family Sales	470	466	519	542	581	59[illegible]	[illegible]6	620	654	533	527	612	651
Housing Starts	1,042	913	989	1,029	1,077	1,12[illegible]	[illegible]95	1,259	1,381	1,203	1,002	1,215	1,314
Single-Family Units	786	724	803	838	868	915	948	988	1,005	901	808	962	1,014
Multi-Family Units	256	189	186	191	209	214	248	271	376	302	194	253	300
2-4 Family Units	31	31	30	31	34	35	40	44	56	37	31	41	49
5+ Family Units	225	159	156	160	175	179	207	227	320	264	163	212	251
Mobile Homes Shipped	178	161	165	169	170	175	176	177	199	188	166	175	168
Percent change -- Year Ago													
Total Single-Family Sales	-13.8	-15.2	-3.9	1.7	10.1	15.9	9.6	8.4	-4.4	-5.9	-2.3	10.2	3.6
Existing Single-Family Sales	-11.9	-10.2	-2.2	2.6	10.0	13.5	7.6	6.1	-3.6	-4.7	-0.2	8.1	3.1
New Single-Family Sales	-27.9	-22.0	-3.8	3.6	23.6	26.9	16.7	14.3	-3.3	-18.5	-1.0	16.2	6.4
Housing Starts	-22.9	-36.3	-17.8	-9.0	3.3	23.6	20.8	22.3	-7.2	-12.9	-16.7	21.3	8.1
Single-Family Units	-20.9	-32.0	-10.4	-2.1	10.3	26.4	18.0	17.8	-7.2	-10.4	-10.3	19.1	5.4
Multi-Family Units	-28.4	-48.7	-39.5	-30.3	-18.3	12.8	33.0	41.8	-7.2	-19.7	-35.8	30.6	18.3
2-4 Family Units	-42.2	-28.7	-30.4	-3.3	9.2	12.8	33.0	41.8	-5.1	-32.8	-15.9	30.6	18.3
5+ Family Units	-26.0	-51.3	-41.0	-33.9	-22.1	12.8	33.0	41.8	-7.6	-17.4	-38.6	30.6	18.3
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	92.2	95.9	97.1	98.3	99.4	100.6	101.7	102.9	92.9	95.2	97.7	102.3	107.3
New Home Prices	122.0	120.4	123.3	125.3	128.3	131.3	132.8	134.4	120.4	122.3	124.3	133.6	140.5
Percent Change - Year Ago													
Existing Home Prices	-0.5	0.5	0.5	1.8	7.8	4.9	4.7	4.7	4.2	2.4	2.6	4.7	4.9
New Home Prices	-2.0	-2.7	-2.6	7.3	5.2	9.1	7.7	7.3	6.2	1.6	1.7	7.5	5.1

Quarterly figures are seasonally adjusted annual rates.

* Total single-family sales equals single-family resales plus 97% of single-family housing starts.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of the current condition of the U.S. economy, easy-to-read forecasts for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets.

If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

Editorial questions can be directed to Robert Barr at (202) 383-7525.

A7000-1

Real Estate OUTLOOK

July 1991

The recent monthly data suggest that the economy has reversed course and is ending the recession which began last July. After ten months without an advance, employment at private, nonfarm establishments increased by 101,000 workers in May. Auto sales and durable goods orders are up, and industrial production has increased in the past two months However, the recovery's progress is expected to be fitful, its pace restrained. Commercial real estate and multifamily construction remain as drags on the economy, and consumers continue to carry high debt burdens. *Page 2*

In May, housing starts increased two consecutive months for the first time this year. After rising 8.2% in April, starts increased 0.1% to an annual rate of 982,000 units. May's weak increase is characteristic of the budding recovery, which is slow but forthcoming. *Page 4*

Sales of existing homes continued to build momentum in May, rising 6.0% to an annual rate of 3.51 million units. This is the highest sales rate since December of 1989. The gain was evenly distributed among the Midwest, South and West, with each region's sales increase averaging near 7.0%. The Northeast was the only region that did not post a gain in May. *Page 6*

Also In This Issue:

Lessons from the Old World	*Economic Commentary by John A. Tuccillo*	*Page 1*
Outlook for the Economy & Real Estate	*Robert D. Barr & Kimberly A. Martin*	*Pages 2-7*
The Credit Crunch: Real Estate in Danger	*NAR Staff Briefing Paper*	*Pages 8-18*

NATIONAL ASSOCIATION OF REALTORS®
REALTOR®
The Voice for Real Estate™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991
NATIONAL ASSOCIATION OF REALTORS®

Lessons From the Old World

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

At the end of June, what Napoleon and Hitler were unable to do with their grand armies and fleets was accomplished by a bunch of laborers with some drilling equipment. The completion of the tunnel linking England and France under the Channel (thus, the "chunnel") was not only an engineering feat, but also a powerful symbol, a fitting prelude to the pending economic unification of Europe next year.

On this side of the pond, we watch the looming merger with both curiosity and dread, mostly because the premier free market country in the world is afraid to compete with the rest of the world. We are afraid that the European behemoth, together with the surging Asian economies, will sandwich and squeeze us into permanent second world status.

Of course, this is precisely the wrong attitude. We need to observe the European experiment, but not fear it. As is the case in most undertakings of this sort, it will fail. As close as they may be, none of these countries will be willing to part with the key parts of their sovereignty, including their monetary unit. So complete integration will not happen. Moreover, the commitments to rebuild the East assumed by the unified German government will severely hamper its ability to participate in a greater Europe.

From our side, there are lessons here, even though much of what is happening is irrelevant. If we look at Europe as a single nation with a bunch of states, a lot of what it is seeking to achieve is old hat in the U.S. The free passage of goods from France to Spain is really no different from the movement between Oklahoma and Arkansas. Common financial terms are no big deal in the United States, yet will be an important accomplishment of Europe '92.

But the very concept of unification is something we need to look hard at. Recently, the Congress was faced with the question of whether we would "fast track" a *de facto* free trade area with Mexico. Opposition came from those elements that feared the displacement of American labor by lower paid Mexican workers (there's that competition thing again!). Although the measure ultimately passed, the uneasiness about lowering the barriers remains.

Ironically, the French and Germans were faced with precisely the same choice. Opening up to the rest of Europe would require competition with less expensive Irish dairy products, with continental farmers the losers. But there's a second side to this process, because as Irish incomes rose, so would the demand for German electronics products and French clothing, with continental manufacturers the winners.

We are in a similar position, but have chosen to protect rather than to grow. Yes, a free trade zone with Mexico would have a negative impact on certain industries, but the net change in total employment that would come from increased demand by Mexican workers for U.S. manufactured goods would be positive. We are the natural supplier for one of the fastest growing populations in the world, and a free trade arrangement will create the effective demand for that supply.

The Europeans have realized this relationship and are acting on it. Economic integration is not a win-win proposition; but in most cases, the winners outnumber the losers. It is very difficult to ignore the cries of the losers, but in an evolving economy growth areas must be fed, even at the expense of some traditionally important sectors.

European economic integration is important, and Asian economic growth is impressive. Yet, neither can stand up to a North American free trade area that capitalizes on the natural resource base of Canada, the productive might of the United States and the scope of the Mexican market. This is the opportunity that faces us if we take the European lesson to heart.

The second lesson from the European case centers on that tunnel. In one sense, it's a luxury item, a convenience for those who've never been to Spain, but kinda like the music. But, in a larger sense, it represents a significant investment in reducing transportation and communications costs in anticipation of a Europe marked by completely free trade. Moreover, together with the high speed rail systems now being developed throughout the continent, the tunnel was "appropriate technology," a capital project well suited to the scale of its need.

And it wasn't easy. The tunnel was expensive and time consuming; its rewards will not come instantaneously. The U.S. economy faces the same types of needs as were met by the "chunnel" in that our infrastructure is aging and in gross need of overhaul and reconstruction. Yet, those expenditures will not pay off tomorrow; rather, they require a longer view and a spending discipline that is not necessarily in vogue in this country now. We are at a crucial economic breakpoint. The recession is over, but the recovery will be weak. In fact, the last quarter of recession may be indistinguishable from the first quarter of recovery. Moderate interest rates and relatively low inflation will foster renewed growth that will continue through 1992.

But the nagging question remains: Where next? It's fairly clear that we don't need another 80's type boom that left us overburdened with both debt and bad economic habits. The larger danger, though, is that we slip into the malaise of the late 70's with slow growth and economic inefficiency. The key to avoiding that is to think in global terms, get away from the narrow parochialisms of the past and learn the lessons of the old world.

Outlook for the Economy

The recovery has made its first, halting steps. Housing markets and auto sales have rebounded in recent months, orders for durable goods are up, industrial production has increased in the past two months, and workers are putting in more hours. Inflation has lost some steam, and short-term interest rates remain low. The data are tentative but, taken together, suggest that the economy has reversed course and is ending, if it has not done so already, the recession which began last July.

The recovery's progress is expected to be fitful, its pace restrained. In fact, the recovery may yet pull up lame, sending the economy into another recessionary dip. Commercial real estate and multifamily construction remain as drags on the economy, governments at all levels are facing a fiscal squeeze, and consumers continue to carry high debt burdens. Long-term interest rates, meanwhile, have stubbornly returned to the same level they were at a year ago. A double-dip of recession wouldn't be unusual; in three of the previous four recessions, there has been a quarter of positive growth before output turned negative once again.

According to NAR's forecast, the return of consumer spending will provide an important toehold for the recovery. In late July, the first figures for GNP growth in the second quarter will be released, and NAR projects they'll show a meager 0.7% annual rate of increase. This will be a transitory quarter for the economy, coming between a 2.8% annual rate of decline in the first quarter of 1991 and an estimated 2.4% rate of growth in the second half of the year. For 1991 as a whole, the economy is projected to decline 0.2% over 1990.

A Green Light from Recent Statistics

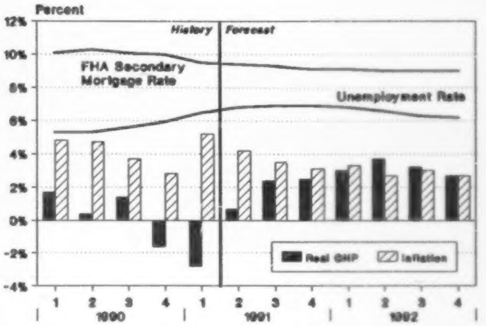
After ten months without an advance, employment at private, nonfarm establishments increased by 101,000 workers in May (revised up from the 49,000 gain previously reported). Indicative of the "two steps forward, one step back" nature of this recovery, the payroll level in June reversed course, declining by 39,000 workers (see chart). But the June report also contained good news in that the average workweek expanded significantly, a usual precursor of increased hiring. Meanwhile, industrial production rallied in April and May and appears to have turned the corner, although it remains 4% below September 1990's peak (see chart). Orders for durable goods have also grown smartly in the past couple of months, one of several measures signalling business's renewed confidence in the health of the economy.

Will the Increase in Consumer Spending Last?

One source of renewed strength in output is consumer spending. After declining at a 2.4% pace in the six months between October and March, consumer spending is projected to have bounced back to a 3.7% annual rate between April and June. Consumers, who held back during the buildup to the Persian Gulf war, increased their spending sharply on durable goods, especially autos, in the second quarter. But once this pent-up demand is dissipated, consumers may again cut back since recent income gains have not been strong enough to support such spending.

For example, in the first five months of 1991, personal spending, after accounting for inflation, rose at a 1.9% annual rate. Income, after adjusting for inflation and taxes, fell at a

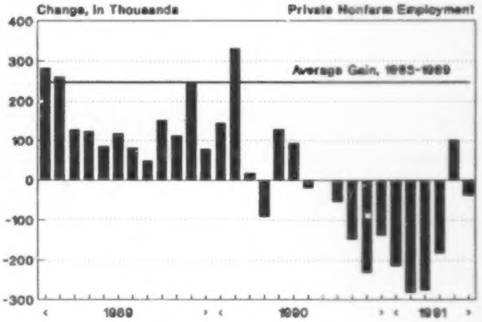
The Economic Outlook



Sources: BEA, BLS, FHLMC, NAR forecast

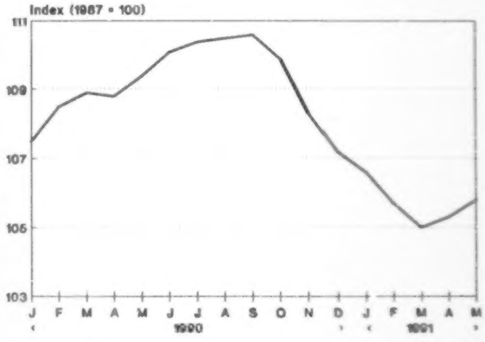
Employment Falters in June

But May's Gain Suggests Recovery Is at Hand



Source: Bureau of Labor Statistics

Industrial Production Turns the Corner in April and May



Source: Federal Reserve

1.0% rate over the same period (see chart). Looking at just the last three months, the gap between spending and income has widened. Although income growth has turned positive, (up a scant 0.3%), spending advanced at a 3.8% rate.

Given this divergence, it's not surprising that the saving rate has fallen, averaging 3.7% in the past three months relative to 4.9% in the same period a year earlier. A falling saving rate and an already high debt burden suggest that the recent strength in consumer spending will be short-lived. This is one major reason why the first two quarters of this recovery are expected to be so sluggish relative to previous recoveries. It also makes predictions of a double-dip plausible, even if not convincing.

There remain important structural shifts in the economy which will also limit performance between now and year-end. The real estate industry remains weak, with multifamily and commercial construction in the doldrums. The defense industry is gearing down, and retailing and financial services are undergoing fundamental shakedowns in their industrial structures. But as resources move away from these areas, they will shift into areas that are (or are expected to be) more profitable. Such sectors that may benefit include the production of capital equipment, exported goods, and single-family residences. The transition will be difficult for affected industries and individuals, but the overall impact on the economy will be positive.

Slower Inflation Improves Recovery's Chances

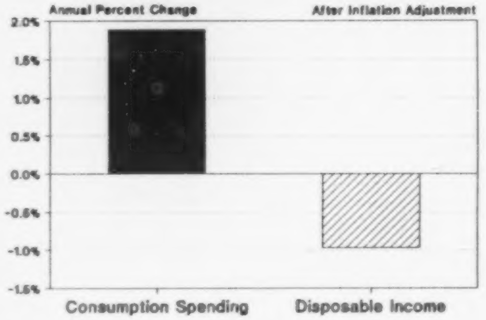
The Consumer Price Index, after excluding the volatile food and energy components, has shown only mild increases in the past three months. As shown in the accompanying chart, this is in contrast to the first two months of 1991. One of the silver linings to be found in recessions is a lower inflation rate, and this recession will not be an exception. The slack in the labor market, represented by June's 7.0% unemployment rate, will temper wage increases and help keep a lid on inflation. The CPI is projected to increase 4.3% in 1991, down from 5.4% in 1990. Improvement is expected to continue in 1992, with a CPI gain of 3.3%.

Since long-term interest rates take account of inflation, then less inflation should allow these rates to fall. A decline in long-term rates would provide relief to interest-sensitive sectors of the economy, such as home-building and the production of capital equipment and durable goods. This would also help the frayed banking sector. The chart at right shows how 30-year mortgage rates have bounced back up recently while adjustable rate mortgages, less dependent on long-term rates, have held steady.

After engineering the sharp fall of short-term rates over the past several months and continuing its vigilance over inflation, the Fed has done about all it can do to lower long-term rates. What's needed is a market convinced that inflation will remain in check. The recent reappointment of Alan Greenspan to head the Federal Reserve Board for another four years will please the financial markets, no doubt. Not complacent with the prevailing 4% inflation rate seen since the early 1980s, Greenspan's Fed has been shooting for price stability, or zero inflation, and, more importantly, has been willing to trade off some current economic pain today for greater economic growth tomorrow.

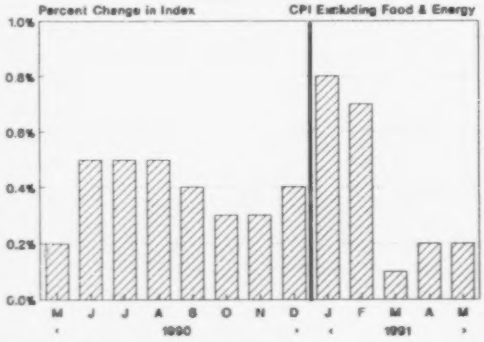
Spending's Up Even as Income Falls

Changes Over the First Five Months of 1991



Source: Bureau of Economic Analysis

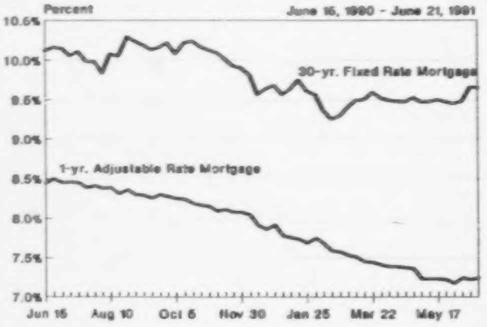
Recent Inflation Performance Improves



Source: Bureau of Labor Statistics

Mortgage Rates Diverge

Growing Gap Reflects Inflation Worries



Source: Federal Home Loan Mortgage Corporation

Housing Starts

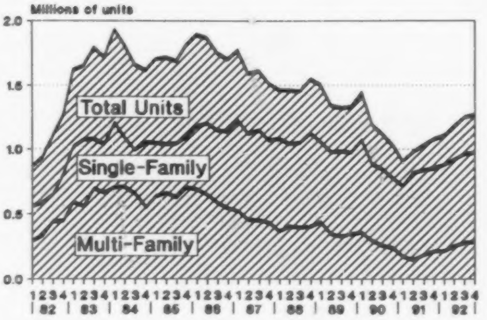
National Data

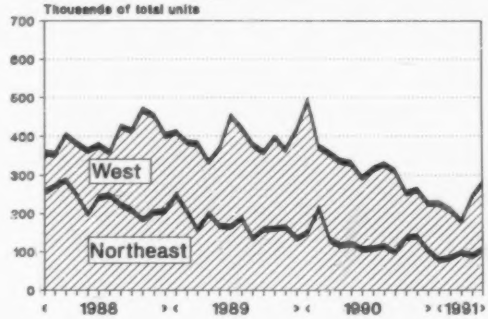
	Total	SF	MF:2-4	MF:5+
May 1990	1,208	897	38	273
Dec 1990	971	751	17	203
Jan 1991	847	648	29	170
Feb 1991	992	788	37	167
Mar 1991	907	742	28	137
Apr 1991	981	807	33	141
May 1991	***982***	***832***	***32***	***118***
Annual Averages:				
1989	1,381	1,005	56	320
1990	1,203	901	37	265
Percent Changes in May 1991 since:				
May 1990	-18.7	-7.2	-15.8	-56.8
Apr 1991	0.1	3.1	-3.0	-16.3

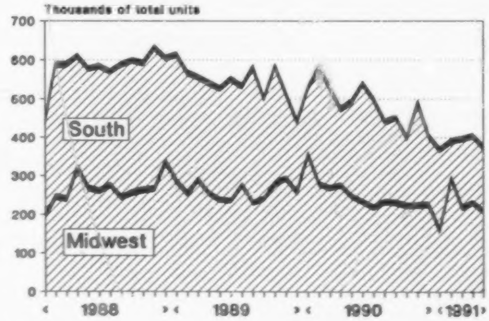
Regional Data

	Northeast	Midwest	South	West
May 1990	128	255	486	339
Dec 1990	110	233	395	233
Jan 1991	86	167	361	233
Feb 1991	91	301	384	216
Mar 1991	104	226	390	187
Apr 1991	96	238	397	250
May 1991	***113***	***217***	***367***	***285***
Annual Averages:				
1989	181	269	535	397
1990	135	259	478	330
Percent Changes in May 1991 since:				
May 1990	-11.7	-14.9	-24.5	-15.9
Apr 1991	17.7	-8.8	-7.6	14.0

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







In May, housing starts increased two consecutive months for the first time this year. After rising 8.2% in April, starts increased 0.1% to an annual rate of 982,000 units. May's weak increase is characteristic of the budding recovery, which is slow but forthcoming. All of the increase came from the strength in the construction of single-family homes, which grew 3.1% to 832,000 units. This is the highest level for single-family starts since October of 1990. The construction of multi-family homes continues to be limited by the lack of credit. Consequently, a 13.8% decline in the construction of multifamily homes partially offset the advances made in the single-family market.

Activity in the four Census reporting regions varied in May. In the Northeast region, where the recession has taken the heaviest toll, construction appears to be bouncing back. There, housing starts grew a lofty 17.7% to 113,000 units. In the West, starts increased 14.0% to 285,000 units. Countering these increases were declines in the Midwest and the South. In the Midwest, starts declined 8.8% from April to 217,000 units, and in the South starts dropped 7.6% to 367,000 units.

Low mortgage rates and the belief that the end of the recession is at hand give second quarter starts a healthy 8.2% gain over the first quarter's rate. During the third quarter of 1991, starts are expected to reach the one million mark. Economic expansion and the easing of the credit crunch are expected to pull multi-family starts up by 39.2% and single-family starts up at a 15.7% clip in 1992. In 1992, total starts are projected to be 20.3% higher than in 1991.

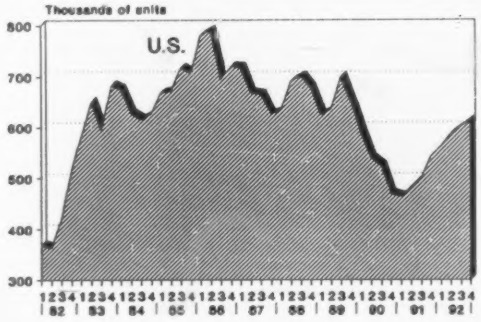
National Data

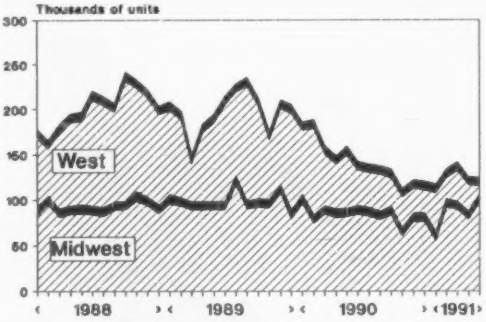
		Mo. Ago % Chg.	Yr. Ago % Chg.
May 1990	535	0.2	-17.8
Jun 1990	549	2.6	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	414	-10.8	-34.0
Feb 1991	488	17.9	-19.5
Mar 1991	491	0.6	-12.2
Apr 1991	490	-0.2	-8.2
May 1991	***474***	***-3.3***	***-11.4***
Annual Averages:			
1989	654		-3.3
1990	534		-18.3

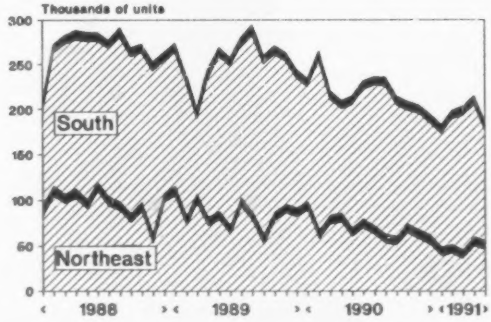
Regional Data

	Northeast	Midwest	South	West
May 1990	70	91	215	159
Dec 1990	62	86	195	121
Jan 1991	49	65	183	118
Feb 1991	52	102	199	134
Mar 1991	46	99	203	142
Apr 1991	60	88	215	126
May 1991	***56***	***107***	***187***	***125***
Annual Averages:				
1989	90	103	258	202
1990	75	90	222	147
Percent Changes in May 1991 since:				
May 1990	-20.0	17.6	-13.0	-21.4
Apr 1991	-6.7	21.6	-13.0	-0.8

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







Activity in the new home sales market stood in contrast to other areas of housing during May. Unlike the pace of housing starts and existing home sales, the pace of new home sales dropped 3.3% to an annual rate of 474,000 units. In all likelihood, builders are being hampered by the continued lack of credit, which is, in turn, causing stagnation in the new home sales market.

Of the four regions, only the Midwest recorded an increase in the sale of new homes. There, sales climbed 21.6%, pushing the annual rate over the 100,000 mark and 17.6% above the rate of a year ago. The South encountered the greatest loss, with new home sales tumbling 13.0%, or 28,000 units. The Northeast saw new home sales fall 6.7% to an annual rate of 56,000 units, while the West saw sales slip 0.8% to 125,000 units.

Despite the decline in new home sales, May's figures continue to support the view that January's poor performance will be the nation's low point. With the approaching recovery, new home sales in the second quarter are expected to post a healthy 4.1% gain over the first quarter's rate. During the third quarter of 1991, new home sales are expected to exceed the half-million mark. As the fourth quarter comes to a close, new home sales will have increased 17.0% from the first quarter, which translates into a gain of 79,000 units.

By 1992, new home sales will be poised for growth. As the economy continues to expand and the lending environment loosens, new home sales are forecast to increase 18.8% in 1992. Thereafter, sales will begin to stabilize, and are projected to increase 6.8% to 632,000 units in 1993.

Existing Home Sales

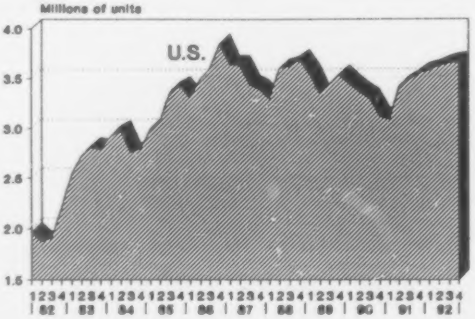
National Data

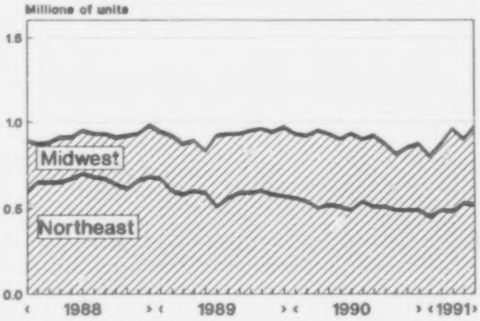
		Mo. Ago % Chg.	Yr. Ago % Chg.
May 1990	3,350	-0.6	3.1
Jun 1990	3,370	0.6	3.1
Jul 1990	3,320	-1.5	1.2
Aug 1990	3,410	2.7	-1.8
Sep 1990	3,160	-7.3	-0.9
Oct 1990	3,070	-2.8	-10.0
Nov 1990	3,150	2.6	-12.0
Dec 1990	3,130	-0.6	-11.5
Jan 1991	2,900	-7.3	-12.1
Feb 1991	3,160	9.0	-16.4
Mar 1991	3,220	1.9	-7.6
Apr 1991	3,310	2.8	-6.4
May 1991	*3,510*	*6.0*	*-1.8*
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

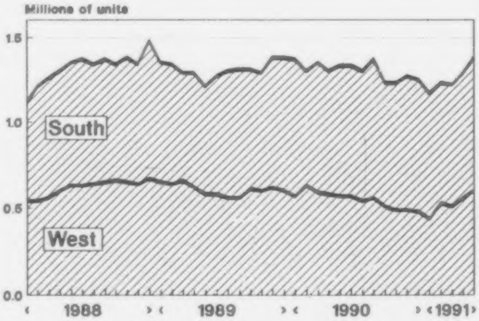
Regional Data

	Northeast	Midwest	South	West
May 1990	520	910	1,340	580
Dec 1990	500	880	1,260	490
Jan 1991	460	810	1,180	450
Feb 1991	500	880	1,240	540
Mar 1991	490	970	1,230	520
Apr 1991	540	910	1,300	570
May 1991	*530*	*980*	*1,390*	*610*
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in May 1991 since:				
May 1990	1.9	7.7	3.7	5.2
Apr 1991	-1.9	7.7	6.9	7.0

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors, 'Home Sales'







Sales of existing homes continued to build momentum in May, rising 6.0% to an annual rate of 3.51 million units. May's figure represents the fourth consecutive increase in the rate of existing home sales and is the highest level since December of 1989. While continued growth should be interpreted as a sign of the incipient recovery, it should also be viewed with some caution. The pent-up demand which gathered during the recession and the Persian Gulf Crisis may have fueled this rebound over the last few months. In all likelihood, these current levels will not be matched over the next few months.

The Northeast was the only region that did not post a gain in resales during May. In spite of this decline, sales remain 1.5% above the average for 1990. The gain was distributed evenly among the remaining three regions. In the Midwest, sales of existing homes displayed the greatest strength, increasing 7.7% from April's 910,000-unit rate. Sales of existing homes increased 7.0% in the West to a rate of 610,000 units. Similarly, the South saw an increase of 6.9%, rising to 1.39 million units.

Existing home sales are expected to post a 10.6% gain over the first quarter's rate. This increase reflects the strong advances made in April and May of this year. Thereafter, sales will continue to grow at a healthy clip, reaching an annual rate of 3.56 million units by the fourth quarter of 1991. The momentum established in 1991 will position the resale market for robust growth in 1992. Sales of existing homes are projected to increase 7.2% in 1992. In 1993, the pace of sales will experience a slight deceleration, increasing 2.3%.

Prices of New & Existing Homes

National Data

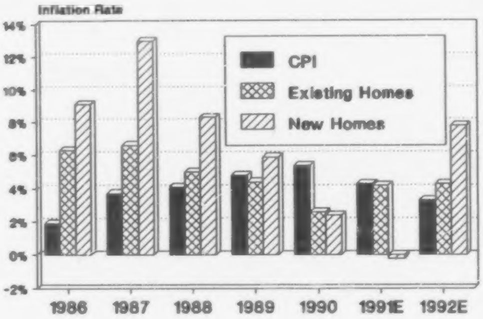
	Median Existing	Median New	Average Existing	Average New
May 1990	95,200	125,000	118,500	150,600
Dec 1990	91,700	127,000	114,100	153,400
Jan 1991	95,600	117,900	123,000	148,600
Feb 1991	94,000	119,900	119,700	147,800
Mar 1991	98,200	122,900	125,200	157,400
Apr 1991	100,300	120,000	128,900	149,400
May 1991	***99,700***	***121,900***	***127,500***	***154,400***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in May 1991 since:				
May 1990	4.7	-2.5	7.6	2.5
Apr 1991	-0.6	1.6	-1.1	3.3

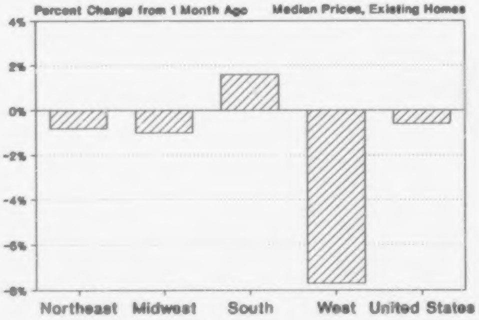
Regional Data

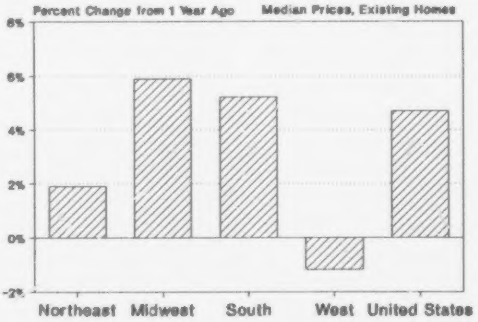
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
May 1990	140,900	72,800	85,000	141,800
Dec 1990	134,400	72,300	82,800	131,400
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	144,800	77,900	88,000	151,800
May 1991	***143,600***	***77,100***	***89,400***	***140,100***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in May 1991 since:				
May 1990	1.9	5.9	5.2	-1.2
Apr 1991	-0.8	-1.0	1.6	-7.7

Levels are shown in dollars.
Source: National Association of Realtors, 'Home Sales'







The national median price of existing single-family homes dipped below the $100,000 level in May. The month's 0.6% decrease pushed the price down to $99,700. May's decline is indicative of the greater quantity of homes purchased in the lower price ranges by entry-level buyers. In the market for new homes, the median price increased 1.6% to $121,900 in May. This increase put the median price of a new home 2.5% below the figure of a year ago.

The average price of an existing home decreased by 1.1% in May to $127,500. Since May of 1990, the average price has risen 7.6%. An increase of 3.3% in May resulted in a gain of $5,000 to the average price of a new single-family home.

Modest appreciation in the median price of an existing single-family home is expected over the current year. For the year, the median price is expected to increase 4.2%, holding prices below the $100,000 mark. Thereafter, the median price of an existing family home will continue to appreciate and should increase 4.3% and 4.5% in 1992 and 1993, respectively. The median price of a new single-family home is expected to retreat in 1991, decreasing 0.2% to $122,000. By 1992, the median price of a new single-family home is projected to appreciate with renewed force, increasing 7.8% to $131,500.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

The Credit Crunch: Real Estate in Danger

From an NAR Staff Briefing Paper

Through a combination of regulatory stringency, a changing financial industry and economic recession, the decline in investment real estate values that infected the Southwest has spread through the country. In some markets, optimism bred from the economic expansion of the Eighties led to overbuilding. But in many more markets, the *ex post* changes in tax rules contained in the Tax Reform Act of 1986 inflicted punitive damages on the real estate industry and ruined ongoing projects. And in even more markets, financial institution regulators drove banks away from real estate credit and starved a great many projects. These changes occured against the backdrop of an anit-inflation campaign staged by the Federal Reserve which limited the ability of banks to make loans.

All of this resulted in the current credit crunch. As depicted in the chart to the right, the growth in lending by commercial banks for real estate-related assets has been severely crimped since the late 1980s. The plunge in growth has been particularly sharp since early 1990.

In the spring of 1991, the Real Estate Finance Division of the NATIONAL ASSOCIATION OF REALTORS® prepared a briefing paper on the impact of the credit crunch on real estate. This article is adapted from that study. Its chief findings include:

- The credit crunch is real. Developer surveys suggest that nearly 95 percent of the respondents have felt the tightening of credit in the past year.
- The real estate industry is a vital cog in the nation's economic machine. Currently the sector accounts for close to a sixth of GNP and employs in excess of 4 million people.
- The Tax Reform Act of 1986 devastated real estate values. Restoration of the pre-1986 treatment of capital gains, passive losses and depreciation lives would increase investment real estate values by 12 to 18 percent.

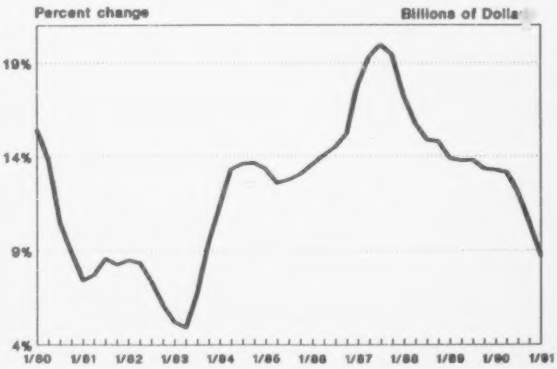
This article focuses on the credit crunch as it affects real estate. After an overview of the credit crunch, we'll briefly discuss the results of two surveys conducted by NAR to measure the depth of the credit crunch. Finally, the changes made in the tax system, an important source of instability in real estate over the past decade, will be discussed.

Overview of the Credit Crunch

The term "credit crunch" describes the increase in difficulty that creditworthy borrowers have ex-

Real Estate Loans

Made by Commercial Banks



Source: Federal Reserve, *Loans & Securities at All Commercial Banks* perienced in receiving credit from lending institutions. First felt in the spring of 1990, the current credit crunch resulted in large part from the reluctance of banks to make loans on real-estate related assets. This reluctance had many sources: the increased scrutiny by regulators after the S&L debacle, the failure of real estate properties to appreciate as they had in the Eighties, and slower growth in the economy.

As loan losses mounted, portfolio values deteriorated and regulatory pressure intensified, banks found themselves in weak financial condition. Loan standards were tightened, and borrowers who were previously able to obtain credit found themselves squeezed out of the credit market.

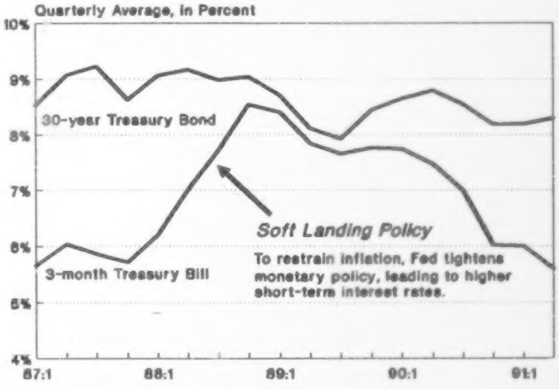
While it's clear that lending activity was falling, it's less clear just what the precise cause is. Increased regulatory pressure would lower the supply of credit, but, on the other hand, the nation's recession would limit demand for credit. If the recession is playing a large role, then the credit crunch is really a product of reduced demand, not restricted supply, and therefore a result of normal market forces which would dissipate when the recession ended. Yet it could be argued that a cutoff in the supply of credit is itself one of the major causes of the recession. The available evidence shows that both supply and demand have reinforced each other in lowering lending activity.

One gauge of changes in lending restrictions is the Federal Reserve's periodic surveys of top lending officers at banks across the country. In November 1990, half of the banks surveyed said they had imposed stiffer terms on business loans in the prior six weeks. In the January 1991, one-third of those surveyed had tightened restrictions in the previous six weeks. By May, the credit crunch seemed to be easing somewhat as only 15 percent of those surveyed had tightened credit.

While restrictions on real estate were srticter than on loans for other business activities, the three surveys show that fewer banks were increasing their requirements for real estate development and construction loans. In the November survey, about two-thirds of the respondents had tightened restrictions for the real estate industry, but by January that figure fell to half, and by May it had fallen to one-quarter of the respondents. Commenting on the surveys before the Senate Finance Committee, Fed Chariman Alan Greenspan suggested that the credit crunch, while not easing, was perhaps reaching its peak.

The Soft Landing

Short- and Long-Term Interest Rates



Source: Federal Reserve, *Selected Interest Rates*

Federal Reserve Credit Policy

The banks' growing reluctance to extend credit to real estate projects wasn't the only genesis of the credit crunch. Even if real estate had been particularly favored, the banks would have found a decreased ability to make any type of loan. This was due to the Federal Reserve's inflation-fighting policy, which limited the growth of credit in the economy.

In attempting to achieve effective price stability, the Fed took aim at lowering the 4 percent rate of inflation that had been prevailing since the early 1980s. Fiscal policy was already highly stimulative (that is, large and persistent federal budget deficits were generating extra demand in the economy), and so the Fed hoped that a well-announced and credible campaign to lower inflation would be effective without pushing the economy into recession. By putting upward pressure on short-term interest rates in 1988, the Fed pursued a "soft landing" policy that would slow the economy but also bring a lower rate of inflation. As the chart shows, short-term rates climbed over two percentage points while long-term rates held steady.

The Fed's actions can be seen more directly when looking at banking reserves, the primary channel by which the Fed supplies new credit to the market. Banks are required to keep a percentage of their deposits at the Federal Reserve in non-interest bearing accounts. Since these funds provide no return to the banks, banks have a strong incentive to minimize these reserves. When the Fed supplies more reserves to the system, banks are able to take the excess, lend it out and consequently make a return. When the Fed drains supplies from the banking system, banks need to send new funds to cover their reserve requirement, leaving less for lending.

With this in mind, note the growth pattern depicted in the accompanying chart showing year-over-year changes in banking reserves. In both 1979 and 1989 -- each a year before a recession and a credit crunch -- reserve growth was negative. In 1988, to put upward pressure on short-term interest rates and thereby institute its soft landing policy, the Fed squeezed reserve growth to 1.8 percent from 14.1 percent a year earlier. This was followed in 1989 by a 0.7 percent *decline* in the level of reserves. Clearly, the Fed's attempt to wring inflation from the economy is one major source of the credit crunch.

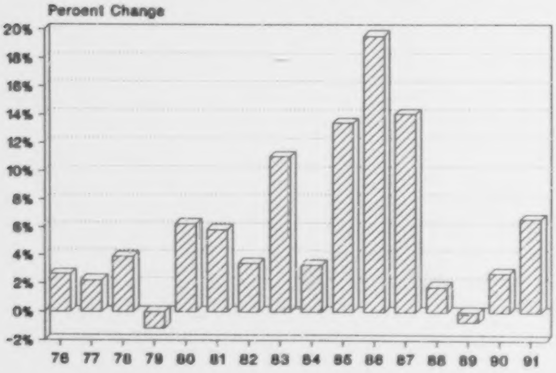
As mentioned earlier, the Fed's policy limited lending throughout the economy, not just in real estate. But real estate was particularly susceptible due to the problems brought on by overbuilding and, in particular, changes in tax laws. The effects of these changes will be discussed later in this article.

Survey Evidence of Problems in Real Estate Markets

NAR conducted two national surveys to determine the extent of the credit crunch. The first survey was conducted in early October, 1990. NAR mailed approximately 16,100 Commercial Credit Condition surveys to ask if commercial financing credit conditions had changed in local market areas over the last six months. The individuals surveyed were primarily commercial real estate brokers and commercial developers. Recipients of the questionnaire included all members of the Society of Office and Industrial REALTORS (SIOR), the Commercial and Investment Real Estate Institute (CIREI) and nearly 8,000 members of the Urban Land Institute (ULI). The survey had a 10 percent response rate, with 1,636 questionnaires returned to NAR.

Growth in Banking Reserves

Credit Crunches Follow '79 and '89 Declines



Source: Federal Reserve, *Aggregate Reserves*.
Data for 1991 is the annualized rate of the first half's growth.

The follow-up survey was conducted in early January, 1991. NAR mailed approximately 14,000 Commercial Credit Condition surveys to all members of SIOR, CIREI, and nearly 5,000 members of ULI. Surveyed individuals were asked about commercial financing credit conditions in their market area over the last six months, with an emphasis on roll-over and permanent acquisition financing for income-producing property. The response rate was slightly higher for the second survey as 12 percent, or 1,612 questionnaires, were returned to NAR.

October survey respondents were asked eleven questions about credit conditions in their market. January survey respondents were asked twelve questions about rollover and permanent financing conditions in their market. A number of salient points can be extracted from these surveys. They include:

- Credit conditions are perceived to have tightened significantly in all regions of the country. More than nine out of ten respondents indicated that their local market had been negatively affected during the last six months. This tightening has been manifested both in a lack of available credit and unfavorable credit conditions.
- Respondents indicated that the regulatory environment was the principal reason for the change in credit conditions, although weak financial institutions and poor market conditions were also mentioned as contributing factors.
- Most survey respondents indicated that they were attempting to make other arrangements for financing as a result of problems with their current lenders. More than three-quarters of respondents indicated that they were searching for alternative financing, while less than 40 percent indicated success in their efforts.
- Comments from respondents in the Midwest (the triangle of states between Ohio, Kansas and North

Dakota) indicated that they had healthy local markets, but that national regulatory pressure was causing local lenders to be overly conservative.

- Office properties were the most widely reported property type experiencing difficulty in acquiring financing, followed by retail properties. In spite of having the highest current returns of all commercial property types, softening in retail markets and consumer pessimism is causing lender caution. Clearly the office market is experiencing difficulty because it is the most overbuilt property type in the majority of market areas.
- For those seeking alternative sources of financing, October respondents seeking permanent financing reported more success for their efforts than did those seeking development or construction financing.
- October survey respondents reported that the S&Ls' role as a market lender had already declined in 1989 and was declining further in 1990. Commercial banks were the primary source of commercial financing in 1990, although they were less active than in 1989. Non-traditional sources of financing -- sellers, private investors, and assumptions -- increased their roles in 1990.
- Over half (53 percent) of the January respondents who attempted to rollover a loan in the previous six months (just over half of all respondents) had difficulty in obtaining that financing. The Northeast (Pennsylvania and above) recorded the greatest proportion of respondents reporting such problems, at 68 percent; the Midwest had the smallest proportion reporting difficulty, at 45 percent.
- Of those January respondents who reported difficulty in obtaining rollover financing, 46 percent indicated that they had a performing loan with a bullet and were unable to rollover the loan with their lender. Thirty-three percent cited difficulty in obtaining permanent financing when having a performing construction loan. Twenty-four percent of these respondents indicated that they had an existing performing loan which was called by their lender.
- Retail properties received the highest share (41 percent) of difficulty in obtaining rollover financing in the January survey. Office properties followed at 34 percent, industrial properties were next at 26 percent, and multifamily properties were mentioned by 24 percent of the respondents.
- A lack of available financing or unfavorable credit terms offered to creditworthy borrowers caused difficulties in selling property for 71 percent of the January respondents. Financing was the most difficult in the South (from Maryland down through Texas) and Northeast and was less difficult in the Midwest, where 60 percent of the respondents reported difficulty.
- Over two-thirds of the January respondents experiencing difficulty in selling property due to financing conditions reported that a creditworthy borrower was unable to obtain permanent financing on income-producing property. Sixty-two percent reported difficulty due to unfavorable financing terms and conditions.
- October survey respondents overwhelming reported that market credit conditions would either decline or remain the same over the next year. Fifty percent of the respondents indicated that credit conditions would worsen in the next twelve months, and only 10 percent indicated that their local market would improve over the next year. The remaining 40 percent believed that conditions would remain the same.
- The picture brightened somewhat in January's survey. Forty-one percent of all January respondents indicated that they expected credit conditions to decline over the next twelve months while 32 percent expected improvement. The remaining 27 percent believed credit conditions would remain the same over the next twelve months. Southern respondents were the most optimistic; Northeastern respondents were the most pessimistic.

The Impact of Destabilizing Tax Policy Changes Over the Past Decade

Among major consumer budget categories, housing is the second largest expenditure item, accounting for roughly one-sixth of total U.S. consumption expenditure. In terms of federal tax policy, housing is the most heavily targeted consumption expenditure of all major budget categories. A major reason tax policy has focused to such an extent on housing is that housing expenditure variations have had a major impact on business cycles both in precipitating recessions and in leading the economy out of recessions.

Over the last ten years, the real estate sector of the U.S. economy has been buffeted by a series of major tax policy changes including, the 1981 Economic Recovery Tax Act (ERTA), the 1984 and 1985 Tax

Reform Acts and the 1986 Tax Reform Act (TRA). The most significant tax reforms have been ERTA and TRA.

Passed during one of the most severe postwar recessions, ERTA was designed to stimulate the economy. The act is perhaps best known for reducing the top marginal income tax rate from 70 to 50 percent. For taxpayers in the highest tax bracket, the cut in the top tax rate reduced the benefit of itemized deductions such as the popular homeowner deductions for mortgage interest and property taxes.

However, ERTA also included provisions directly targeted to boost the housing sector of the economy. In addition to reducing the top marginal income tax rate, the act reduced the marginal tax rate on long-term capital gains for the highest-income investors from 28 percent to 20 percent, and shortened the tax lifetime for residential rental property from 32 to 15 years.

As a result, investment in housing and commercial real estate development increased significantly in many markets between 1981 and 1984. In fact, ERTA was so successful in boosting the real estate sector of the economy that Congress increased the tax lifetime for real property to 18 years in 1984 and to 19 years in 1985.

TRA Replaces Tax Incentives with Disincentives

In 1986, the impact of the 1984 and 1985 tax acts was dwarfed by TRA, which completely reversed most of the economic recovery provisions enacted in 1981 as part of ERTA. TRA eliminated the distinction between capital gains and other types of income and raised the top marginal tax rate to 33 percent. Moreover, TRA extended the tax lifetime for residential properties to 27.5 years and for commercial properties to 31.5 years. The Act also required straight-line depreciation rather than the faster 175 percent declining balance method.

Passive Loss Restrictions Discriminate Against Real Estate Investments

On top of these conventional changes, the passive activity loss provision contained in TRA created a new category of income called passive income. Under this provision, income is deemed passive if it is derived from the conduct of a trade or business and the taxpayer does not materially participate in the activity. This provision especially discriminates against real estate. With minor exceptions, all income from rental real estate activities is considered "passive," regardless of the level of the investor's participation in the activity that generates the income. Losses from passive activities such as rental real estate, to the extent they exceed income from such activities, generally may not be deducted from other income, such as salary and portfolio income. Some taxpayers, however, may be eligible to offset up to $25,000 of nonpassive income annually by net losses and credits from rental real estate activity. To qualify, the taxpayer must actively participate in the rental real estate activity. The $25,000 amount is reduced by 50 percent of the amount by which a taxpayer's annual adjusted gross income (AGI) exceeds $100,000. Thus at an AGI of $150,000, the exemption disappears.

For taxpayers who have used up their respective allowance or who have AGIs in excess of $150,000, passive losses may only be used to offset passive income. In cases where passive losses exceed passive income, the excess losses are suspended and carried forward to offset passive income that might arise in subsequent years and, to the extent not used, are allowed to offset other income in the year a taxpayer disposes of his interest in the activity. Although investors in passive activities are permitted to offset passive losses eventually, they may have to sustain such losses for many years. During this period they are denied any earnings from money tied up in the suspended losses.

In addition, the limitation on passive losses also raises the after-tax risk of rental projects, since it provides limited loss-offset in unprofitable projects. The higher risk associated with rental projects is translated immediately into higher capitalization rates for rental real estate projects. Moreover, the loss limitations also discourage high-leverage rental projects because the interest deductions in these projects are no longer as valuable to their investors.

Disincentives Contained in TRA Cause Abrupt Drop in Property Values

Almost overnight, the present values of most real estate projects plummeted when TRA was enacted. The results of standard cash flow analysis shown in Table I reveal how the present value of a typical residential rental property, operating before TRA, would have dropped more than 20 percent after TRA was enacted.

Case 1 in Simulation One shown in the table indicates that a residential rental property generating an average net income for such a property and subject to typical financial assumptions would have had a present value of $7,447,345 and an after-tax internal

Table I:
Tax Policy Changes and Property Values

Incremental Effects of Selected Provisions of the 1986 Tax Reform Act on the Value of a Residential Rental Property

Assumptions:

Price	$7,447,345	Capitalization Rate	8.7%
Land Value as a Percent of Price	15.0%	Initial Annual Operating Costs	$665,855
Furniture and Fixtures as a Percent of Price	5.0%	Initial Annual Rents	$1,313,774
Structures as a Percent of Price	80.0%	Growth Rate of Operating Costs	4.0%
Downpayment as a Percent of Price	10.0%	Growth Rate of Rents	4.0%
Interest Rate	10.0%	Inflation	4.0%

Case	Cumulative Changes to Pre-1986 Tax Law	Before-Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	PVof Property Required to Yield A/T IRR Under Pre-1986 Tax Law	Cumulative Change in PVof Property Required to Yield A/T IRR Under Pre-1986 Tax Law
	Simulation One: Passive Loss Limits Applied Before Depreciation Rule Changed				
1	No Change	19.2%	33.1%	$7,447,345	0.00%
2	28% Top Income Tax Rate	19.2%	23.8%	$6,567,345	-11.82%
3	28% Top Capital Gains Tax Rate	19.2%	22.7%	$6,487,345	-12.89%
4	Passive Loss Limits Apply	19.2%	16.2%	$5,944,000	-20.19%
5	Depreciation Under 1986 Rule	19.2%	16.2%	$5,930,000	-20.37%
	Simulation Two: Depreciation Rule Changed Before Passive Loss Limits Applied				
1	No Change	19.2%	33.1%	$7,447,345	0.00%
2	28% Top Income Tax Rate	19.2%	23.8%	$6,567,345	-11.82%
3	28% Top Capital Gains Tax Rate	19.2%	22.7%	$6,487,345	-12.89%
4	Depreciation Under 1986 Rule	19.2%	18.9%	$6,037,345	-18.93%
5	Passive Loss Limits Apply	19.2%	16.2%	$5,930,000	-20.37%

Notes: PV - present value; simulation results derived using planEASe Economic Analysis System.

rate of return (A/T IRR) of 33.1 percent before TRA. Because the A/T IRR is determined in the capital markets (and is therefore a given in the analysis), the before-tax IRR and the value of the property are the only two variables that could change in response to TRA. Since rents are assumed to be held in check by a large inventory of existing buildings, only the price of the property can change in the short run. Thus, because TRA causes the projected A/T IRR to fall given the existing property value and rent, the value of the property after TRA has to drop 20.37 percent to $5,930,000 in order to maintain an unchanged A/T IRR of 33.1 percent.

Because many tax provisions were enacted simultaneously with TRA and since the effect of each of these provisions is interdependent with each of the other provisions, it is difficult to assess the precise effect of individual provisions on the present value of the property. Comparison of Simulation One and Simulation Two shows that the measured effect of passive loss limits and 1986 depreciation rules depends on the order in which it is assumed such provisions are enacted.

In Simulation One, it is assumed that TRA is implemented one provision at a time beginning with a cut in the marginal income tax rate, then an increase in the capital gains rate, then application of passive loss limits and finally a change in depreciation rules. The reduction in marginal income tax rates by itself reduces the property's present value by 11.82 percent. Dropping marginal income tax rates and raising the top capital gains tax rate cause a 12.89 percent decline in present value. Applying passive loss limits in addition to all of the previous changes would reduce the property's present value by 20.19 percent, assuming that all passive losses must be carried forward to be offset against future passive income. As the final case shows, adopting all of the above tax changes plus the 1986 depreciation rule results in a 20.37 percent decline in the property's present value. From these results, it appears that the passive loss limits account for 7.3 percentage points (20.19% - 12.89%) of the 20.37 percent decline, or more than one third of the total decline.

Rearranging the order in which the tax provisions are implemented, however, significantly alters the apparent effect of each provision on the property's present value. For example, in Simulation Two, the 1986 depreciation rule is assumed to be adopted before the passive loss limits are applied. Under this assumption, the depreciation rule accounts for 6.04 percentage points (18.93%-12.89%) of the 20.37 percent decline, representing slightly less than a third of the total decline.

The substantial changes in the effects of both the passive loss limitations and the 1986 depreciation rule on the property's present value caused by the order in which each provision is implemented show that each effect is closely related to both provisions. In other words, the benefit of more rapid depreciation is smaller to the extent that passive losses can only be used to offset passive gains, since passive losses resulting from faster depreciation must be deferred; and the benefit of being allowed to offset ordinary income with passive losses is smaller to the extent that depreciation benefits are reduced, since more rapid depreciation, in many cases, is a major source of passive losses.

Although rearranging the order in which the tax provisions of TRA are implemented alters the apparent effect of each provision, the 20.37 percent total decline in the property's present value remains unaffected. This predicted decline in the property's present value however, requires that all passive losses are carried forward. The total decline would be slightly less to the extent that an individual is not fully constrained by the passive loss limits, either because he meets the qualifications required to be able to offset up to $25,000 of passive losses against active income, or because he has sufficient net passive gains from other activities. However, most individuals undertaking an investment of this magnitude, on average, are likely to be fully constrained by the passive loss limitations.

Tax Policy Changes Affect Real Estate First, Then Savings and Loans

After nearly five years of priming the real estate pump, Congress suddenly reversed course in 1986, abruptly choking the industry. While it was conceded, at the time that real estate investors would suffer losses as a result of TRA at first, it was argued that such losses would be at least partially offset by rising rents because the new tax laws would discourage new construction which, in turn, would force up rents of existing buildings. As it turns out, however, the supply of existing buildings has been sufficient to keep downward pressures on rents for many years.

With the rules changed virtually overnight and with only limited provisions included to apply the new tax laws gradually so as to allow investors to adjust, investors suddenly found themselves having to swallow 15 to 20 percent declines in the values of their real estate portfolios. Reductions in project values of this magnitude were sufficient to push many marginal

Table II:
Tax Policy Changes and Property Values

Incremental Effects of Selected Tax Policy Changes on the Value of a Residential Rental Property

Assumptions:

Price	$7,447,345	Capitalization Rate	8.7%
Land Value as a Percent of Price	15.0%	Initial Annual Operating Costs	$665,855
Furniture and Fixtures as a Percent of Price	5.0%	Initial Annual Rents	$1,313,774
Structures as a Percent of Price	80.0%	Growth Rate of Operating Costs	4.0%
Downpayment as a Percent of Price	10.0%	Growth Rate of Rents	4.0%
Interest Rate	10.0%	Inflation	4.0%

Case	Cumulative Changes to 1990 Tax Law & Basic Assumptions	Before-Tax Internal Rate of Return (IRR)	Projected After-Tax Internal Rate of Return (A/T IRR)	PVof Property Required to Yield A/T IRR Under 1990 Tax Law	Cumulative Change in PVof Property Required to Yield A/T IRR Under 1990 Tax Law
	Simulation One: 28% Marginal Income Tax Rate				
1	No Change	19.2%	16.2%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.2%	18.9%	$7,760,000	4.20%
3	20% Top Capital Gains Tax Rate	19.2%	20.0%	$7,906,000	6.16%
4	Pre-1986 Depreciation Rule	19.2%	23.8%	$8,250,000	10.78%
5	Capitilization Rate Falls to 8.2%	19.2%	24.3%	$8,330,000	11.85%
	Simulation Two: 32% Marginal Income Tax Rate				
1	No Change	19.2%	16.2%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.2%	19.3%	$7,810,030	4.87%
3	20% Top Capital Gains Tax Rate	19.2%	20.6%	$7,980,000	7.15%
4	Pre-1986 Depreciation Rule	19.2%	25.2%	$8,410,000	12.93%
5	Capitilization Rate Falls to 8.2%	19.2%	26.5%	$8,610,000	15.60%
	Simulation Three: 34% Marginal Income Tax Rate				
1	No Change	19.2%	16.2%	$7,447,345	0.00%
2	Passive Loss Restrictions Removed	19.2%	18.8%	$7,830,000	5.14%
3	20% Top Capital Gains Tax Rate	19.2%	20.9%	$8,120,000	9.03%
4	Pre-1986 Depreciation Rule	19.2%	26.0%	$8,570,000	15.10%
5	Capitilization Rate Falls to 8.2%	19.2%	27.3%	$8,800,000	18.20%

Notes: PV - present value; simulation results derived using planEASe Economic Analysis System.

projects into insolvency. Since, according to most sources, mortgages and mortgage-backed securities account for almost 86 percent of all savings and loan assets, the significant increase in real estate investment failures in turn reduced the solvency of many marginally solvent savings and loans. Thus, where Congress originally sought to bring the economy out of recession by boosting the housing sector, it eventually contributed to the current decline in the economy by hitting the housing sector abruptly with costly tax changes that significantly lowered asset values which, in turn, substantially exasperated an existing tightness in credit markets.

Potential Changes in the 1986 Act to Ameliorate Current Market Problems

Reversing the Trend in Real Estate Prices

One of the basic underlying causes of the current credit crunch is the perception, justified or not, that real estate under current market conditions in many regions represents an inferior investment opportunity. The downward trend of real estate prices in many markets that had experienced sustained and rapid price appreciation has reduced expectations with respect to the future earning potential of real estate investments. In time, the market will eventually adjust to the radical changes in tax policy brought about by the Tax Reform Act of 1986 (TRA), resulting in a reduced supply of housing and commercial buildings and higher rents. Given the severity of the shock to the industry caused by TRA, however, the adjustment period could be relatively long, causing persistent harm both to the banking sector and to the economy in general.

One policy option that could reduce this adjustment period would be to mitigate the severity of certain provisions of TRA. As shown in the preceding simulations, the provisions that have particularly hurt the real estate industry include those pertaining to the treatment of passive activity income, capital gains and depreciation rules. Table II reveals the cumulative impact of modifying these provisions on the value of the same typical residential rental property assumed in the previous simulations.

Simulation Results of Potential Tax Policy Changes

Three simulations are included to show the impact of each provision under different assumptions regarding an investor's marginal income tax rate. The 1990 tax act maintains the 28 percent tax bracket and establishes a new maximum tax bracket of 31 percent beginning at a taxable income of $49,300 for a single return and $82,150 for a joint return for 1991. In addition to establishing a higher maximum rate, the act also imposes a reduction in the non-exempt itemized deductions in the amount of 3 percent of adjusted gross income (AGI) over $100,000 for single filers and married couples filing jointly. The reduction in non-exempt itemized deductions adds an additional 1 percentage point to the maximum marginal income tax rate for taxpayers with AGIs above $100,000. Thus the top marginal tax rate for some taxpayers is 32 percent.

The 1990 tax act also adds approximately 0.5 percent to a taxpayer's marginal tax rate for each personal exemption claimed if the taxpayer's AGI exceeds $150,000. As a result, a married couple with two children and AGI in excess of $150,000 could have a marginal tax rate of 34 percent. It is likely that the marginal investor in commercial real estate has a marginal income tax rate nearer 34 percent than 28 percent. To consider several possibilities, the marginal income tax rate is assumed to be 28 percent in Simulation One, 32 percent in Simulation Two, and 34 percent in Simulation Three.

If passive loss restrictions are removed, as assumed in case 2, the increase in the projected A/T IRR ranges from 2.7 percentage points in Simulation One to 3.3 percentage points in Simulation Three. The change in the value of the property required to leave the actual A/T IRR unchanged ranges from 4.2 percent in Simulation I to 5.14 percent in Simulation Three.

Case 3 assumes Case 2's removal of passive loss restrictions and lowers the top capital gains tax rate to the pre-TRA rate of 20 percent. The resulting value of the property would have to increase by at least 6.16 percent in Simulation One and by as much as 9.03 percent in Simulation Three to leave the respective A/T IRRs unchanged.

Case 4 combines these tax policy changes with a return to the pre-1986 depreciation rules, which results in a cash flow that would require at least a 10.78 percent increase in the property's value in Simulation One and a 15.10 percent increase in Simulation Three to yield the respective actual A/T IRRs.

The Impact of Tax Reform on Capitalization Rates

If the passive loss restrictions are removed, investors in real property of this nature, which typically yields substantial losses until it is sold, will be more certain that they will be able to bear such sustained losses until a profit can be realized since they will be able to offset such losses against income from non-passive activity. Investors will no longer have to speculate whether they will be able to generate sufficient passive gains to offset passive losses as they occur. This reduction in uncertainty would reduce the riskiness of such an investment, which would result in a lower capitalization rate since a significant component of the capitalization rate is a risk premium.

The lower capitalization rate, in turn, would result in a higher property value given that property value is equal to the flow of income net of expenses discounted by the capitalization rate. Case 5 shows that the increase in value of this property could range from 11.85 percent in Simulation One to 18.20 percent in Simulation Three if in conjunction with all of the above tax policy changes, the capitalization rate were to fall from its current rate of 8.7 percent to 8.2 percent.

Shortening the Adjustment Period with Tax Policy Changes

Cash flow analysis shows that changes in tax policy could increase the value of real property substantially. Rising real estate values, in turn, could increase the willingness of lenders to underwrite real estate projects. The improved tax environment coupled with easier access to credit could substantially reduce the adjustment period required for the real estate sector to recover from the effects of TRA

Federal Government Responses to the Credit Crunch

Belatedly, the Administration has recognized the existence of the credit crunch. The most substantive response to the credit crunch from the Administration is the regulators' joint supervisory policies announcement. The four federal banking and thrift institutions regulators' plan proposes guidelines clarifying specific regulatory and accounting principles intended to "contribute to a climate in which banks and thrifts will make loans to creditworthy borrowers and work constructively with borrowers experiencing financial difficulties...." Specific points central to the joint agencies' plan are recognition of income for certain non-performing loans; valuation of real estate loans in examinations; and guidance on issues relating to nonaccrual assets and formally restructured debt. The regulators expressed concerns that the "availability of credit to sound borrowers" should not be "adversely affected by supervisory policies of depository institutions misunderstanding about them."

This article is adapted from an NAR Staff Study: **The Impacts of Tax Policy and Regulation on Real Estate and Financial Institution Soundness.** *(April 1991). Principal contributors to the study were:*

John A. Tuccillo	*Senior Vice President & Chief Economist*
Frederick E. Flick	*Division Vice President Forecasting & Policy Analysis*
Robert D. Barr	*Director, Forecasting*
L. George Griffin	*Director, Policy Analysis & Development*
Patria Smith Kunde	*Director, Group Investment*
Donald R. Leavens	*Director, Tax Research*
Forrest W. Pafenberg	*Director, Real Estate Finance*
Orawin T. Velz	*Economist, Tax Research*

The study was edited for the Real Estate Outlook by Robert Barr.

References

Boskin, J. Michael, "Tax Policy and Economic Growth: Lesson from the 1980s," *Journal of Economic Perspectives*, vol. 2, no. 4, fall, 1988, 71-97.

CBO, IRS, OMB changes in income distribution, income payment, deductions etc. (Wealthy taxpayers are declaring more taxable income and paying more taxes as a result of TRA)

Council of Economic Advisors, **Economic Report of the President**, *U.S. Government Printing Office*, Feb. 1991.

DiPasquale, Denise and William Wheaton, "The Cost of Captial, Tax Reform and the Future of the Rental Housing Market," *MIT Center for Real Estate Development*, wp. 18, 1990.

Duke, Paul Jr., "Fewer Banks Are Tightening Lending; Fed Chief Sees Credit Crunch Peaking," *The Wall Street Journal*, Sec. A, Pg. 2, Col. 2, May 17, 1991.

Earl, John H., Jr., "Real Estate Investment and the Tax Reform Act of 1986," *Journal of Real Estate Development*, vol. 2, no. 4, Spring 1987, 33-40.

Follain, James R., Patric H. Hendershott and David C. Ling, "Understanding the Real Estate Provisions of Tax Reform: Motivation and Impact," *National Tax Journal*, vol. XL, no. 3, 363-372.

Goulder, Lawrence "Tax Policy, Housing Prices and Housing Investment," mimeo.

Gravelle, Jane G., "Differential Taxation of Capital Income: Another Look at the 1986 Tax Reform Act," *National Tax Journal*, vol. XLII, no, 4, 441-63.

Hendershott, Patric H., "The Tax Reform Act of 1986 and Real Estate," *MIT Housing Policy Project*, MIT, 1988.

Laurence H. Meyer and Assoc., **The WUMM Model Book**, Sept. 1989.

Meltzer, Allan H., "There Is No Credit Crunch," *The Wall Street Journal*, Sec. A, Pg. 12, Col. 4, February 8, 1991.

Murray, Alan and Paul Duke Jr., "Bush, Aides, Regulators Meet to Discuss Bank Credit Crunch's Effect on Economy," *The Wall Street Journal*, Sec. A, Pg. 2, Col. 3, November 15, 1990.

NATIONAL ASSOCIATION OF REALTORS, **Home Sales Yearbook**, 1989.

Neubig, Thomas S. and David Joulfaian, "The Tax Expenditure Budget Before and After the Tax Reform Act of 1986," *Tax Policy.*

Poterba, James M., "Taxation and Housing Markets Preliminary Evidence on the Effects of Recent Tax Reforms," *NBER Working Papers Series*, no. 3270, 1990.

Rosen, Kenneth T. and Janet Spratlin, "The Impact of Tax Reform on the Mortgage Market," *Focus on Finance*, vol. 4, no. 1, Summer 1988.

Uchitelle, Louis, "Bankers Expected to Stay Hestitant to Lend For Years," *The New York Times*, Sec. A, Pg. 1, Col. 6, July 5, 1991.

U.S. Economic Outlook: July 1991

	90.4	91.1	91.2	91.3	91.4	92.1	92.2	92.3	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-1.6	-2.8	0.7	2.4	2.5	3.0	3.7	3.2	2.5	1.0	-0.2	2.8	2.9
Industrial Production	-7.2	-9.6	0.5	1.4	4.5	4.1	6.3	6.1	2.6	1.0	-2.6	4.4	5.4
Civilian Employment	-0.9	-2.4	0.0	2.4	1.4	1.2	1.4	1.7	2.0	0.5	-0.5	1.4	1.4
GNP Inflation Index	2.8	5.2	4.2	3.5	3.1	3.3	2.7	3.0	4.1	4.1	4.0	3.1	2.9
Consumer Prices	7.0	3.5	2.2	3.7	3.4	3.2	3.2	3.9	4.8	5.4	4.3	3.3	3.5
Value of the U.S. Dollar	-19.0	8.0	46.5	11.9	3.8	1.7	0.7	-0.1	6.2	-9.6	3.9	5.0	-1.0
Percent													
Mfg. Capacity Utilization	80.8	78.0	77.5	77.4	78.0	78.6	79.6	80.6	84.0	82.3	77.8	80.1	83.4
Civilian Unemployment	5.9	6.5	6.8	6.8	6.8	6.8	6.7	6.5	5.3	5.5	6.7	6.6	6.1
Percent of GNP													
Federal Tax Receipts	20.4	20.4	20.4	20.4	20.5	20.7	20.7	20.7	20.2	20.3	20.4	20.7	20.7
Federal Expenditures	23.7	22.7	23.0	23.7	24.0	24.1	23.9	23.6	22.8	23.3	23.3	23.8	23.3
Federal Budget Deficit	-3.3	-2.3	-2.6	-3.2	-3.4	-3.5	-3.2	-3.0	-2.6	-3.0	-2.9	-3.1	-2.6
Interest Rates, Percent													
Federal Funds Rate	7.7	6.4	5.8	5.8	6.1	6.2	6.4	6.5	9.2	8.1	6.0	6.4	6.5
3-Month T-Bill Rate	7.0	6.0	5.6	5.6	5.8	6.0	6.1	6.2	8.1	7.5	5.8	6.1	7.8
Prime Rate	10.0	9.2	8.7	8.5	8.5	8.5	8.5	8.5	10.9	10.0	8.7	8.5	8.5
Discount Rate	6.9	6.2	5.7	5.5	5.5	5.7	5.9	5.9	6.9	7.0	5.7	5.9	6.1
Corporate AAA Bond Yield	9.3	8.9	8.9	9.1	8.9	8.7	8.6	8.6	9.3	9.3	9.0	8.6	8.4
30-Year Government Bond Yield	8.5	8.2	8.3	8.2	8.1	8.0	7.9	7.9	8.4	8.6	8.2	7.9	7.8
Mortgage Rates, Percent													
30-Year Fixed Rate	10.0	9.5	9.5	9.3	9.2	9.2	9.1	9.0	10.3	10.1	9.4	9.1	8.9
1-Year Adjustable	8.1	7.6	7.3	7.2	7.1	7.0	7.0	7.0	9.3	8.4	7.3	7.0	7.0
Home Sales & Starts													
Thousands													
Total Single-Family Sales*	3,879	3,798	4,222	4,308	4,393	4,449	4,526	4,600	4,413	4,164	4,180	4,548	4,702
Existing Single-Family Sales	3,117	3,093	3,420	3,487	3,558	3,587	3,626	3,654	3,440	3,296	3,389	3,633	3,717
New Single-Family Sales	470	464	483	502	543	563	588	602	650	534	498	592	632
Housing Starts	1,042	915	990	1,044	1,091	1,119	1,192	1,265	1,376	1,193	1,010	1,215	1,341
Single-Family Units	786	726	827	847	862	889	928	976	1,003	895	815	944	1,015
Multi-Family Units	256	189	163	197	229	231	264	289	373	298	195	271	325
2-4 Family Units	31	31	33	40	46	45	50	54	55	38	38	51	54
5+ Family Units	225	158	130	157	183	186	214	236	318	260	157	220	271
Mobile Homes Shipped	178	161	171	189	194	205	217	221	199	188	179	215	232
Percent change -- Year Ago													
Total Single-Family Sales	-13.8	-15.2	-0.2	4.4	13.3	17.1	7.2	6.8	-4.4	-5.9	0.0	8.8	3.4
Existing Single-Family Sales	-11.9	-10.2	1.7	5.8	14.2	15.9	6.0	4.8	-3.6	-4.7	2.8	7.2	2.3
New Single-Family Sales	-27.9	-22.3	-10.4	-4.1	15.5	21.2	21.7	19.8	-3.3	-18.5	-6.7	18.8	6.8
Housing Starts	-22.9	-36.1	-17.8	-7.7	4.7	22.3	20.4	21.2	-7.5	-13.3	-15.3	20.3	10.4
Single-Family Units	-20.9	-31.8	-7.7	-1.1	9.6	22.4	12.2	15.2	-7.3	-10.8	-8.9	15.7	7.6
Multi-Family Units	-28.4	-48.7	-47.1	-28.2	-10.4	21.9	61.9	46.8	-8.0	-20.1	-34.7	39.2	20.1
2-4 Family Units	-42.2	-27.1	-24.8	26.2	48.0	43.7	53.8	32.5	-5.8	-32.1	0.1	34.9	7.5
5+ Family Units	-26.0	-51.5	-50.7	-35.4	-18.5	17.6	64.0	50.5	-8.3	-18.0	-39.7	40.2	23.0
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	92.2	95.9	99.7	100.1	101.0	102.0	103.0	103.9	93.1	95.5	99.2	103.4	108.1
New Home Prices	122.0	120.2	120.9	121.6	125.2	128.8	130.8	132.4	120.0	122.9	122.0	131.5	138.9
Percent Change - Year Ago													
Existing Home Prices	-0.5	0.5	3.2	3.6	9.5	6.3	3.3	3.8	4.4	2.6	4.2	4.3	4.5
New Home Prices	-2.0	-2.9	-4.5	4.2	2.6	7.1	8.2	8.9	5.9	2.4	-0.2	7.8	5.6

Quarterly figures are seasonally adjusted annual rates.

* Total single-family sales equals single-family resales plus 97% of single-family housing starts.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of the current condition of the U.S. economy, easy-to-read forecasts for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets.

If you would like to subscribe to the *Real Estate Outlook,* contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

Editorial questions can be directed to Robert Barr at (202) 383-7525.

A 2[illegible]-1

Real Estate OUTLOOK

August 1991

While the recovery may be underway, recent economic statistics suggest the economic locomotive is not steaming ahead. Job growth was negative in July, and orders for durable goods fell sharply in June. While the economic fundamentals still remain weak, several factors nevertheless continue to suggest recovery. Businesses are expanding production in order to restock inventories, and long-term interest rates are expected to fall a bit further as upbeat inflation reports continue to roll in. Taken together, these factors suggest that the recovery will be able to motor along and avoid the much-discussed double-dip. *Page 2*

Housing starts increased for the third consecutive month in June. An increase of 5.2% brought the annual rate of housing starts to 1.040 million units. The average for the second quarter of 1991 is 9.5% above the first quarter's figure. Accounting for much of the increase was a surprising 29.8% increase in housing starts in the Northeast. *Page 4*

The rate of existing home sales continued its ascent in June. An increase of 1.4% put the rate of existing home sales at its highest level since January of 1989. The momentum established in the first half of 1991 is expected to position the resale market for stable growth over the forecast period. *Page 6*

Also In This Issue:

These Meddlesome Priests	*Economic Commentary by John A. Tuccillo*	*Page 1*
Outlook for the Economy & Real Estate	*Robert D. Barr & Kimberly A. Martin*	*Pages 2-7*
Historical Data Tables		*Pages 8-14*

NATIONAL ASSOCIATION OF REALTORS®
REALTOR® *The Voice for Real Estate*™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991
NATIONAL ASSOCIATION OF REALTORS®

These Meddlesome Priests

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

Last month, President Bush reappointed Alan Greenspan to the Chair of the Federal Reserve Board. While the timing was uncertain, the issue was never in doubt. The Chair has the power to affect crucially the life of the nation, and the ability to exercise that power depends on the ability to persuade. The Chairman of the Fed these days is not really an independent agent. Rather, he must be able to bring his colleagues along with his thinking while balancing pressures from the outside. In this sense, Mr. Greenspan has done an excellent job of navigating the political shoals of both the Administration and his own Open Market Committee.

The Greenspan Fed is open to criticism that it held rates too high too long and initiated this recent recession. Perhaps that's true. But the policy chosen by the Fed was a compromise with the zero-inflation faction that forms a sizable bloc within the Fed's decision process. This group would subordinate economic events to the goal of eliminating any increase in prices. Hence, the degree to which Greenspan could move against recession was limited strictly by his ability to pull the needed votes.

Similarly, the Fed has resisted the Administration's prodding to reinflate quickly to pull the economy out of recession. In part for political reasons, and in part because it has no other ideas, the Administration has leaned on the Fed to expand. We learned a long time ago that the short-term political benefit of pushing the inflation rate is not worth the long term economic pain. In remembering this, the Greenspan Fed has done us all yeoman service.

Unfortunately, this is perhaps the only positive economic news coming out of Washington as the President and the Congress seem hell bent on fixing what ain't broke and ignoring what is. And the long-term consequences of this short-term thinking will invariably be negative. In particular, the economic policy establishment seems hell-bent on meddling in the process by which the financial system is changing. But let's examine three areas.

1. *The Recession*. The recession of 1990-91 was, statistically, a mild one. In character, it was much like the slowdown of a decade ago, a wringing out of excesses -- inflation then, financial profligacy now. But this Administration hasn't used this correction to promote a growing future. Rather, like the residents of the Hotel California, they stabbed it with their steely knives, but could not kill the beast.

We live in an economy that has extinguished whole classes of jobs and awaits the generation of others. Yet, there is no movement to provide the incentives for investment that will create those jobs, no climate that will promote the modernization of our capital, no plan that will lead this economy into the world of the next decade. Simply returning the market to the tax regime that prevailed before August of 1986 would move us miles toward being a globally competitive market in the next century.

Contrast this with the rather clear direction set by public policy coming out of the 1980-82 recession. While you can in hindsight claim that policy ultimately set off forces we now regret, it was at least an active effort to move the economy.

2. *The Resolution Trust Corporation*. The process set up to untie the thrift snarl has become an institution that seems as short-term in nature as the National Archives. The goal of liquidating the assets of failed thrifts in a manner consistent with orderly markets and at maximum recovery to the government has been buried in some musty warehouse. RTC sales contracts run to 45 pages, and listings can be pulled at any time with no explanation or compensation.

For the seized institutions themselves, the process is no better. Congress, deathly afraid that someone, somewhere, is making a profit (what country did you say this was?) looks over every sale to ensure that the strictest possible terms are enforced. The net result is that not one penny of capital is likely to flow into the remains of the thrift industry, and the Congress will have finished off what it began with the Tax Reform Act of 1986.

Ultimately, the reluctance of the Congress to take bold actions and to trust the private sector will render the RTC a failure. Sports injuries occur most frequently to those who are least prepared to compete and most afraid of being hurt. As it stands now, we are setting ourselves up for a career-ending shot.

3. *Government-sponsored Enterprises*. One of the major reasons why the collapse of the thrift industry had little impact on residential mortgage finance was the presence of an active secondary market, led by Fannie Mae and Freddie Mac. Now the Treasury and the Congress, having "fixed" the failed thrift problems are attempting to "fix" the residential secondary market. Both seek to impose onerous capital standards on the secondary market agencies.

Are there problems in Fannie and Freddie? No. And perhaps that's the reason for the legislative blitzkrieg. In this age of failed thrifts, rocky commercial banks, and doubtful insurance companies, there is something unsettling about financial institutions that are profitable, well-managed and consumer beneficial. Sure sounds like a case for Congressional action. The capital standards now under consideration would most likely cost the consumer a percentage point on the mortgage rate, but it would produce a level playing field: Fannie and Freddie would be as badly off as the thrifts and banks.

This brings us full circle to the Fed. It has succeeded over a long period of time and under a variety of Chairs, because it does what it does and does it well. It has a long view, a fundamental trust of market capitalism and refuses to enter into fields where it is neither needed nor wanted. There has been a recent debate over whether the Fed should be subject to more control by the Congress and the Administration. I believe the terms of the debate, in the national interest, ought to be reversed.

Outlook for the Economy

The economy's forward progress in the spring gave the impression that the recovery was building up a powerful head of steam. But many recent statistics suggest that we may have only witnessed a train rolling along a downgrade, with little real power of its own. Job growth was negative in July, and orders for durable goods fell sharply in June. Once the momentum from the spurt of activity following the Gulf War is spent, we may find that our economic locomotive is actually sputtering, not steaming ahead.

While the economic fundamentals still remain weak, several factors nevertheless continue to suggest recovery. Businesses are expanding production in order to restock the inventories depleted in the first half of the year. The engineers at the Federal Reserve eased monetary policy in early August, with an eye toward promoting additional growth. After declining impressively in the first half of August, long-term interest rates are expected to fall a bit further as positive inflation reports continue to roll in (see chart). Taken together, these factors suggest that the recovery will be able to motor along and avoid the much-discussed double dip of recession. A 2.4% growth rate is projected for the third quarter, and growth over the next four quarters is expected to average 2.9%, which is low for a recovery. Compared to a meager 1.0% rise in 1990, real GNP, as measured on a year-over-year basis, is projected to drop 0.2% in 1991 before gaining 2.9% in 1992.

Consumers Lead Second-Quarter Rebound

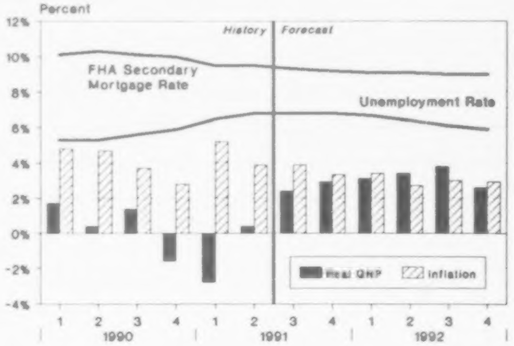
A springtime spurt in consumer spending helped the economy reverse its decline and post a small 0.4% annual rate of increase in the second quarter. Expenditures on autos rose sharply, and overall consumer spending rose 3.6% after falling at a 2.5% rate in the previous six months. In fact, consumer spending seemed especially healthy since its growth rate in the second quarter was three times the rate recorded during 1989, the last full year of expansion.

But it's important to note that consumer spending usually does much better as the economy comes out of a recession. During the next twelve months, growth in consumption will be only half of the 5.0% increase recorded in the year following the 1981-82 recession. The slow pace is due to the soft gains in employment and income that are expected.

Rebuilding Inventories Should Boost Growth

Because a significant portion of the goods consumers loaded into their shopping baskets during the second quarter came out of inventories, not current production, the level of inventories fell (see chart). By another measure, which computes the ratio of total inventories to the total sales rate, inventories remain well in control; according to the most recent data, the ratio fell sharply from March to May. With almost $73 billion of stock liquidated in the past nine months, businesses are likely to build up inventories to more normal levels in the third quarter. Although inventories are expected to drop again by less than $3 billion in the second quarter, the lower rate of reduction is expected to be an important contributor to growth in the third quarter. In fact, about three-quarters of the quarter's projected 2.4%

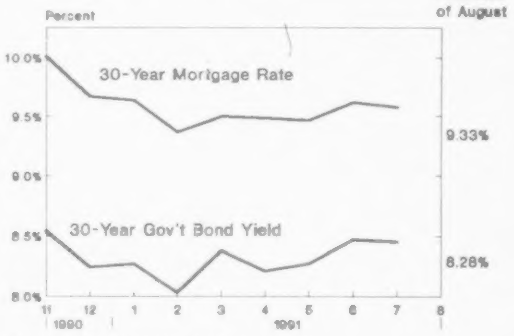
The Economic Outlook



Sources: BEA, BLS, FHLMC, NAR forecast

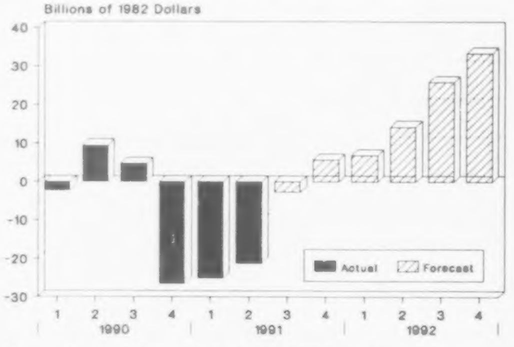
Long-Term Rates Fall in August

Mortgage Rates at Their Lowest Since February



Source: Federal Reserve Board

Inventory Liquidation in First Half Sets Stage for Growth



Source: Bureau of Economic Analysis; NAR forecast growth rate can be attributed to a sharply slower rate of inventory reduction.

Will Consumers Remain at the Party?

Sluggish growth in consumer spending would provide business with some unwanted help in its goal of replenishing stockpiles. If industry overshoots in its production schedules in the third quarter (consequently building up inventories too fast), then a correction in the fourth quarter would dampen the youthful recovery. With both consumers and businesses cutting back, and governments at all levels restricted by their own fiscal squeeze, then it's possible that the economy could slip back into recession.

What makes such a double-dip scenario plausible is the way that the growth in personal income has lagged the growth in consumer spending (see chart). In the second quarter, spending rose 3.6% while income was up only 1.1%, after accounting for inflation and taxes. As a consequence, the personal saving rate slipped to 3.7% from 4.2% the quarter before. With income growth lagging and the saving rate dropping, the fundamental supports to consumer spending appear weak.

Long-Term Rates Drop After Fed Eases

Citing an uneven and fragile recovery, the Federal Reserve purchased some insurance against slipping back into recession by lowering their target on the federal funds rate, a key short-term interest rate. The Fed had been reluctant to ease monetary policy further for fear of fanning any inflationary flames that may result from the recovery. The Fed's governors are also cognizant that the current period -- the transition between recession to recovery -- has been the most perilous for monetary policy. Often the Fed has overstimulated a budding recovery with the result that the extra (and, in hindsight, unnecessary) nudge to grow turned into additional inflation.

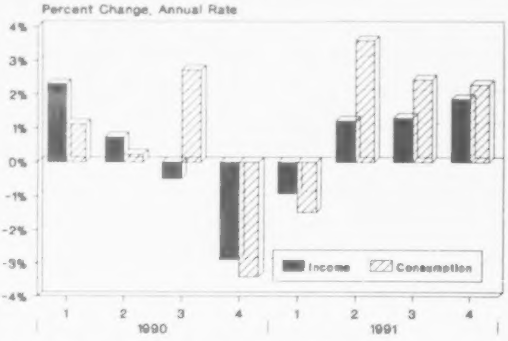
On the other hand, besides the other signs of weakness, the growth in the nation's money supply had slipped to the low end of the Fed's target in the past few months, as shown at right. This was of concern, since falling money supply growth could be a precursor of slower economic activity. With inflation apparently in check (see chart), the Fed thought it had both the reason and the room to ease.

One hurdle keeping the recovery from being robust is the high long-term interest rates, and the Fed's move might have sent them higher. These rates would have crept up if the market had thought that the move was unwarranted -- meaning that the Fed didn't buy extra real growth, just more inflation. The financial markets apparently thought that the move was appropriate, however, for rates fell. Within two weeks, the yield on 30-year government bonds dropped from 8.4% to 8.2%, and 30-year mortgage rates fell from 9.5% to 9.3%. This implies that the market accepted the Fed's view that the economy needed help, and that the help, in the form of looser monetary policy, would be noninflationary.

As it is, inflation continues as the bright spot in the economy. The Consumer Price Index, for example, is expected to fall by about a percentage point a year in the next two years -- from 5.4% in 1990 to 4.3% in 1991 and then to 3.5% in 1992.

Spending Outpaces Income

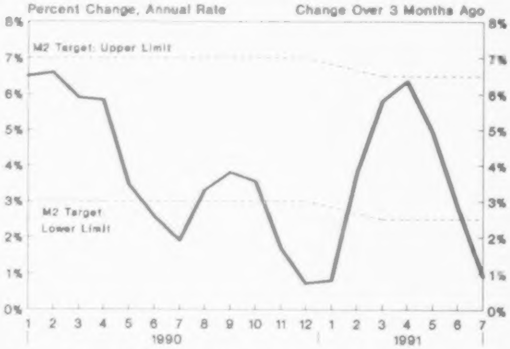
Real Disposable Income & Consumer Expenditures



Source: Bureau of Economic Analysis; NAR forecast

Money Growth Sharply Lower

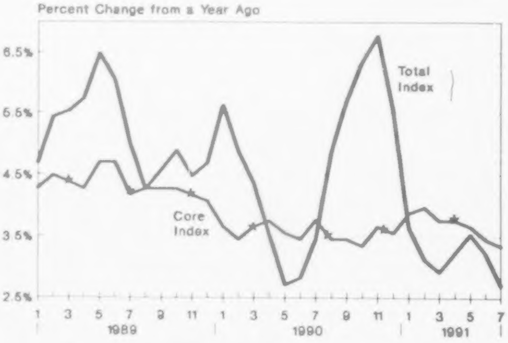
M2 Slips Below the Lower Bound of Its Target



Source: Federal Reserve Board

Producer Prices Show Restraint

Less Food & Energy, Index Decelerates to 3.5%



Source: Bureau of Labor Statistics

Housing Starts

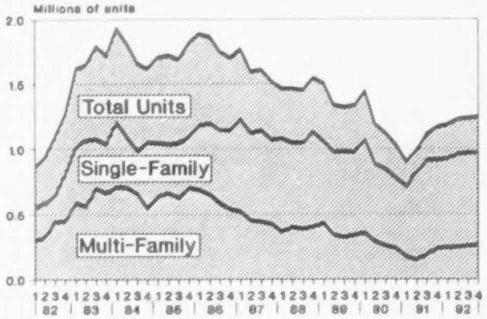
National Data

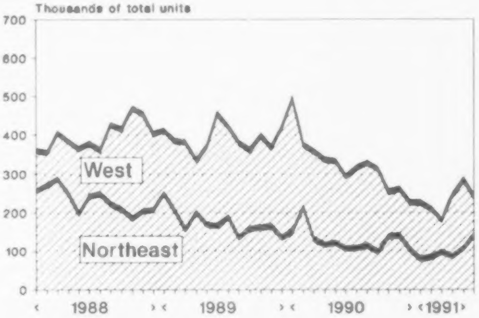
	Total	SF	MF:2-4	MF:5+
Jun 1990	1,187	890	41	256
Jan 1991	847	648	29	170
Feb 1991	992	788	37	167
Mar 1991	907	742	28	137
Apr 1991	977	801	32	144
May 1991	989	836	32	121
Jun 1991	***1,040***	***868***	***30***	***142***
Annual Averages:				
1989	1,376	1,003	55	318
1990	1,193	895	38	260
Percent Changes in June 1991 since:				
Jun 1990	-12.4	-2.5	-26.8	-44.5
May 1991	5.2	3.8	-6.3	17.4

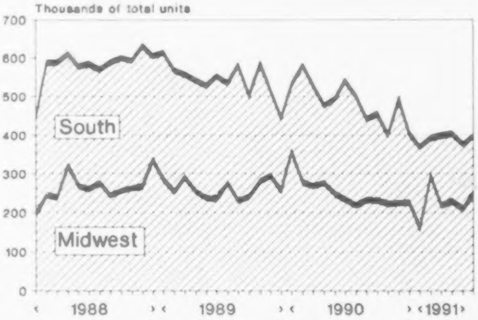
Regional Data

	Northeast	Midwest	South	West
Jun 1990	114	241	532	300
Jan 1991	86	167	361	233
Feb 1991	91	301	384	216
Mar 1991	104	226	390	187
Apr 1991	93	236	395	253
May 1991	114	217	367	291
Jun 1991	***148***	***255***	***389***	***248***
Annual Averages:				
1989	179	266	536	396
1990	131	253	479	329
Percent Changes in June 1991 since:				
Jun 1990	29.8	5.8	-26.9	-17.3
May 1991	29.8	17.5	6.0	-14.8

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







Housing starts surpassed the 1 million mark in June, increasing 5.2% from May's rate of 989,000 units. After increasing in each of the last three months, second quarter starts posted a healthy 9.5% gain over the first quarter's rate.

June's performance is further evidence that housing markets are regaining strength. The construction of multifamily homes with 5 or more units surged 17.4% to 142,000 units. However, a 6.3% decline in the construction of multifamily homes with 2 to 4 units tempered these gains. Overall, multifamily starts increased 12.4%. Advances were also made in the construction of single-family homes, with starts increasing 3.8% to a rate of 868,000 units.

Building activity in the Northeast accounted for much of the increase in June. After rising 22.6% in May, starts increased another 29.8% in June, bringing the annual rate to 148,000 units. The Midwest also posted a hefty gain. There, starts increased 17.5% to 255,000 units. In the South, starts increased 6.0% to 389,000 units, while a decline of 14.8% in the West brought the rate of starts down to 248,000 units.

According to the NAR forecast, housing starts will increase 12.9% during the third quarter of this year. Single-family starts will account for 72% of the total gain. Fueled by lower mortgage rates and a looser lending environment in 1992, total starts are expected to post a healthy 17.1% gain over 1991. This improved environment is expected to boost the multifamily construction market, with multifamily starts forecast to increase 32.6% in 1992. The single-family construction market will benefit as well, with starts increasing 13.4%.

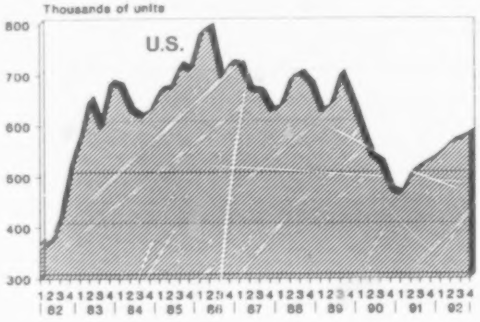
National Data

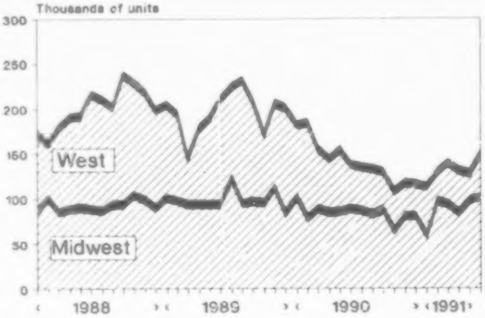
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jun 1990	549	2.8	-15.0
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	414	-10.8	-34.0
Feb 1991	488	17.9	-19.5
Mar 1991	495	1.4	-11.4
Apr 1991	505	2.0	-5.4
May 1991	489	-3.2	-8.4
Jun 1991	***525***	***7.4***	***-4.4***
Annual Averages:			
1989	650		-3.7
1990	534		-17.8

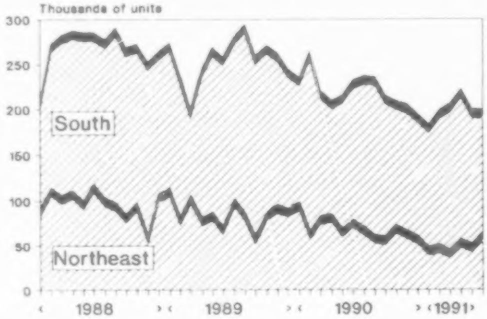
Regional Data

	Northeast	Midwest	South	West
Jun 1990	80	94	232	143
Jan 1991	49	65	183	118
Feb 1991	52	102	199	134
Mar 1991	46	99	206	144
Apr 1991	58	90	222	136
May 1991	53	103	200	133
Jun 1991	***66***	***106***	***199***	***153***
Annual Averages:				
1989	86	102	260	202
1990	71	89	225	149
Percent Changes in June 1991 since:				
Jun 1990	-17.5	12.8	-14.2	7.0
May 1991	24.5	2.9	-0.5	15.0

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







After a downturn in May, the new home sales rate increased 7.4% in June, climbing to the half-million mark. Despite the increase, sales remain 4.4% below one year ago, and, measured on a year-to-date basis, 14.4% below the first half of 1990.

Sales activity in the four Census reporting regions varied in June. In the Northeast, where the recession has taken the heaviest toll, new home sales increased a surprising 24.5% to an annual rate of 66,000 units. New home sales were also strong in the West. There, sales reached their highest level since March of 1990, increasing 15% to an annual rate of 153,000 units. In the Midwest, the pace of new home sales edged up only 2.9% to an annual rate of 106,000 units. The South was the only region to see a decline in new home sales in June. In that region, the pace of new home sales deteriorated 0.5% to an annual rate of 199,000 units.

As the economy recovers and mortgage rates continue to fall, the demand for new homes is expected to grow. According to the NAR forecast, the rate of new home sales is projected to increase 2.4% and 2.3% during the third and fourth quarters of 1991, respectively. In the first half of 1992, the pace of new home sales is expected to accelerate, with increases of 3% and 3.5% in the first and second quarters of 1992, respectively. For the remainder of 1992, new home sales will continue to increase, but at a slower pace. For all of 1992, new home sales are projected to post a 12.3% gain over 1991.

Lower mortgage rates will continue to stimulate new home sales into 1993. Overall, the rate of new home sales is forecast to increase 7.4% to an annual rate of 609,000 units in 1993.

Existing Home Sales

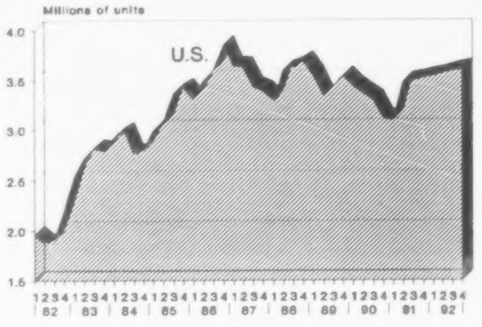
National Data

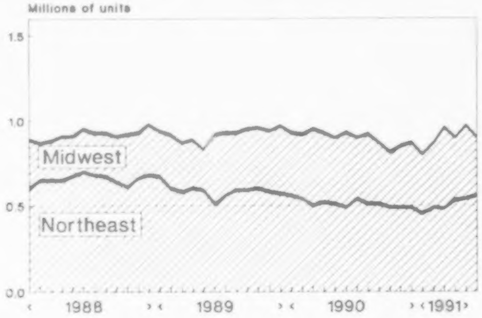
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jun 1990	3,370	0.6	1.2
Jul 1990	3,320	-1.5	1.2
Aug 1990	3,410	2.7	-1.8
Sep 1990	3,160	-7.3	-0.9
Oct 1990	3,070	-2.8	-10.0
Nov 1990	3,150	2.6	-12.0
Dec 1990	3,130	-0.6	-11.5
Jan 1991	2,900	-7.3	-12.1
Feb 1991	3,160	9.0	-16.4
Mar 1991	3,220	1.9	-7.6
Apr 1991	3,310	2.8	-6.4
May 1991	3,540	6.9	-1.8
Jun 1991	***3,590***	***1.4***	5.7
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

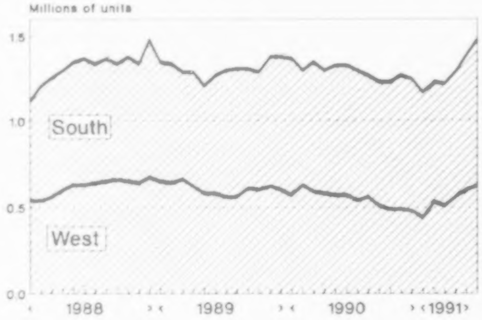
Regional Data

	Northeast	Midwest	South	West
Jun 1990	500	940	1,340	580
Jan 1991	460	810	1,180	450
Feb 1991	500	880	1,240	540
Mar 1991	490	970	1,230	520
Apr 1991	540	910	1,300	570
May 1991	550	980	1,400	610
Jun 1991	***570***	***910***	***1,490***	***630***
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in June 1991 since:				
Jun 1990	14.0	-3.2	11.2	8.6
May 1991	3.6	-7.1	6.4	3.3

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors, 'Home Sales'







The rate of existing home sales continued its ascent in June. After increasing 6.9% in May, the resale rate grew another 1.4% in June to 3.59 million units. June's figure is the highest rate since January of 1989, and increases in April, May and June translate into a gain of 12.5% over the first quarter of this year.

Of the four Census reporting regions, the Midwest was the only region that did not post a gain in resales during June. There, sales fell 7.1% to an annual rate of 910,000 units.

Each of the remaining regions saw increases in existing home sales in June. In the South, existing home sales increased 6.4% from May's rate of 1.5 million units. Sales of existing homes increased 3.6% in the Northeast to a rate of 570,000 units. Similarly, the West saw an increase of 3.3%, rising to an annual rate of 630,000 units. In each of the regions experiencing increases, the resale rate is above its year-ago figure.

The outlook for existing home sales is optimistic. While the strong gains in the second quarter are probably a reaction to the end of the uncertainty surrounding the Persian Gulf war and thus unsustainable, by year end sales are expected to post a 13.9% gain over the first quarter's rate. This translates into a gain of 429,000 units. For the year as a whole, sales are expected to increase 3.1% in 1991.

The momentum established in 1991 will position the resale market for stable growth in 1992 and 1993. In 1992, sales are projected to increase 5.3% to an annual rate of 3.58 million units. In 1993, the rate of existing home sales will continue to increase, but at the slower pace of 2.4%.

Prices of New & Existing Homes

National Data

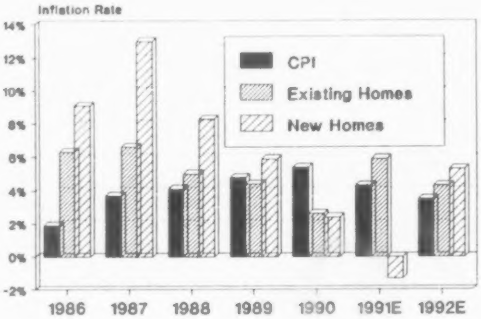
	Median		Average	
	Existing	New	Existing	New
Jun 1990	98,900	125,000	122,500	150,400
Jan 1991	95,600	117,900	123,000	148,600
Feb 1991	94,000	119,900	119,700	147,800
Mar 1991	98,200	122,500	125,200	156,400
Apr 1991	100,300	120,700	128,900	150,000
May 1991	101,100	117,100	130,600	149,700
Jun 1991	***101,900***	***120,000***	***130,300***	***148,500***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in June 1991 since:				
Jun 1990	3.0	-4.0	6.4	-1.3
May 1991	0.8	2.5	-0.2	-0.8

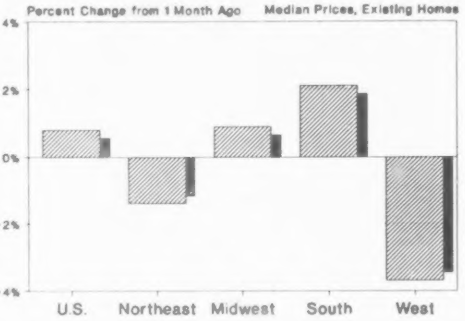
Regional Data

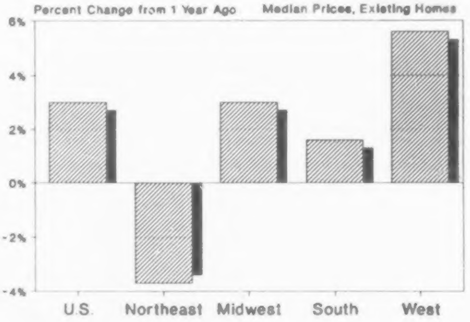
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Jun 1990	148,300	75,900	89,400	138,700
Jan 1991	136,900	74,500	84,600	149,600
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	144,800	77,900	88,000	151,800
May 1991	144,900	77,500	88,900	152,100
Jun 1991	***142,800***	***78,200***	***90,800***	***146,400***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in June 1991 since:				
Jun 1990	-3.7	3.0	1.6	5.6
May 1991	-1.4	0.9	2.1	-3.7

Levels are shown in dollars.
Source: National Association of Realtors, 'Home Sales'







For the fourth consecutive month, the median price of existing single-family homes rose in June. The median price followed May's 0.8% increase with another 0.8% gain in June to stand at $101,900. Over the past twelve months, the median price has risen 3.0%. Home sellers are benefiting from lower interest rates, which have generated more buying activity and have lessened pressure on sellers to lower prices. Although mortgage rates have risen slightly from their mid-winter lows, they remain low relative to rates a year ago.

Meanwhile, in the market for new homes, the median price partially reversed May's 3.0% decline with a 2.5% increase in June. It now stands at $120,000, down 4.0% from the median price one year ago.

The average price of an existing home deteriorated 0.2% in June to $130,300. When compared with June of 1990, the average price has risen 6.4%.

For the remainder of 1991, the median price of existing homes is expected to appreciate modestly. An overall increase of 5.9% in 1991 will hold the median price at the $100,000 mark. In 1992 and 1993, the median price will continue to appreciate, increasing 4.3% and 4.4%, respectively. The median price of new single-family homes is expected to fall 1.3% in 1991. By 1992, however, prices are expected to appreciate with renewed force, and the median price is projected to increase 5.3% to $127,100.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

These historical tables are featured in the February, May, August and November issues of the Real Estate Outlook.

Economic Indicators

	GNP	CPI	Unemployment Rate	Mortgage Rate	Short-Term Rate	Long-Term Rate
	Percent Change	*Percent Change*	*Percent*	*Percent*	*Percent*	*Percent*
Annual						
1980	-0.2	13.5	7.2	13.8	11.4	11.3
1981	1.9	10.4	5.8	10.6	9.4	9.0
1982	-2.5	6.2	6.4	12.9	11.1	10.3
1983	3.6	3.2	9.6	13.2	8.6	11.2
1984	6.8	4.4	7.5	13.9	9.5	12.4
1985	3.4	3.5	7.2	12.4	7.5	10.8
1986	2.7	1.9	7.0	10.2	6.0	7.8
1987	3.4	3.7	6.2	10.2	5.8	8.6
1988	4.5	4.1	5.5	10.3	6.7	9.0
1989	2.5	4.8	5.3	10.3	8.1	8.4
1990	1.0	5.4	5.5	10.1	7.5	8.6
Quarterly						
1984:1	10.7	5.8	7.9	13.3	9.2	12.0
2	5.5	3.8	7.4	14.0	9.8	13.2
3	2.6	3.5	7.4	14.5	10.3	12.7
4	1.7	3.5	7.3	13.7	8.8	11.7
1985:1	4.9	3.7	7.2	13.1	8.2	11.6
2	2.4	3.7	7.3	12.8	7.5	11.0
3	4.1	2.5	7.2	12.1	7.1	10.6
4	3.0	4.1	7.0	11.7	7.2	10.0
1986:1	6.6	2.1	7.0	10.6	6.9	8.8
2	-1.8	-1.9	7.2	10.3	6.1	7.5
3	0.8	2.5	7.0	10.2	5.5	7.4
4	2.3	2.8	6.8	9.7	5.4	7.5
1987:1	5.2	5.4	6.6	9.1	5.5	7.5
2	4.2	4.6	6.3	10.3	5.7	8.5
3	4.1	4.1	6.0	10.5	6.0	9.1
4	6.6	3.8	5.8	10.9	5.9	9.2
1988:1	5.1	3.2	5.7	10.1	5.7	8.6
2	3.6	4.7	5.5	10.4	6.2	9.1
3	2.7	5.2	5.5	10.5	7.0	9.2
4	2.7	4.3	5.3	10.4	7.7	9.0
1989:1	3.6	5.0	5.2	10.8	8.5	9.0
2	1.6	6.2	5.3	10.7	8.4	8.7
3	1.7	3.2	5.3	10.0	7.8	8.1
4	0.3	4.0	5.3	9.8	7.7	7.9
1990:1	1.7	7.4	5.3	10.1	7.8	8.4
2	0.4	3.9	5.3	10.3	7.7	8.7
3	1.4	6.9	5.6	10.1	7.5	8.8
4	-1.6	7.0	5.9	10.0	7.0	8.5
1991:1	-2.8	3.5	6.5	9.5	6.0	8.2
2	0.4	2.1	6.8	9.5	5.6	8.3

Note: Quarterly levels and percentages are annualized. Quarterly figures may not average to annual figures due to rounding. The 3-Month Treasury Bill is shown as "Short-Term Rate"; The 30-Year Treasury Bond is showr as "Long-Term Rate."

Housing Starts

Thousands of Units, Seasonally Adjusted; Percent Change

	Total		Single-Family		Multi-Family	
Annual						
1980	1,300	-24.3	855	-27.0	445	-18.4
1981	1,096	-15.7	711	-16.9	386	-13.4
1982	1,057	-3.6	663	-6.7	394	2.3
1983	1,705	61.3	1,065	60.6	641	62.4
1984	1,768	3.7	1,098	3.1	669	4.5
1985	1,741	-1.5	1,071	-2.5	671	0.2
1986	1,812	4.0	1,182	10.4	630	-6.1
1987	1,631	-10.0	1,154	-2.4	476	-24.3
1988	1,488	-8.7	1,083	-6.2	405	-15.0
1989	1,376	-7.5	1,003	-7.4	373	-7.9
1990	1,193	-13.3	895	-10.8	298	-20.1
Quarterly						
1984:1	1,940	12.2	1,221	16.0	719	6.3
2	1,829	-5.7	1,103	-9.6	726	1.0
3	1,671	-8.7	1,004	-9.0	667	-8.1
4	1,630	-2.4	1,066	6.2	565	-15.4
1985:1	1,714	5.2	1,064	-0.2	650	15.2
2	1,726	0.7	1,053	-1.0	673	3.4
3	1,701	-1.4	1,059	0.6	642	-4.6
4	1,825	7.3	1,108	4.6	717	11.7
1986:1	1,899	4.1	1,198	8.1	701	-2.2
2	1,878	-1.1	1,215	1.5	663	-5.5
3	1,759	-6.4	1,161	-4.4	597	-9.9
4	1,712	-2.6	1,155	-0.5	557	-6.8
1987:1	1,761	2.9	1,237	7.1	524	-5.9
2	1,612	-8.5	1,138	-8.0	474	-9.6
3	1,625	0.8	1,163	2.2	462	-2.5
4	1,524	-6.2	1,079	-7.3	445	-3.7
1988:1	1,425	-6.5	1,057	-2.0	368	-17.2
2	1,491	4.6	1,066	0.9	425	15.3
3	1,484	-0.4	1,071	0.5	413	-2.8
4	1,551	4.5	1,137	6.1	414	0.4
1989:1	1,464	-5.6	1,026	-9.8	438	5.8
2	1,360	-7.1	999	-2.7	362	-17.5
3	1,348	-0.9	1,003	0.4	346	-4.4
4	1,352	0.2	994	-0.9	358	3.5
1990:1	1,433	6.0	1,064	7.1	369	3.2
2	1,204	-16.0	896	-15.8	308	-16.5
3	1,131	-6.1	856	-4.4	274	-10.9
4	1,042	-7.8	786	-8.2	256	-6.7
1991:1	915	-12.2	726	-7.7	189	-26.0
2	1,002	9.5	835	15.0	167	-11.8

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

Housing Starts by Region

Thousands of Units, Seasonally Adjusted; Percent Change

	Northeast		Midwest		South		West	
Annual								
1980	125	-30.9	218	-34.0	647	-12.6	309	-33.4
1981	117	-6.5	175	-19.7	565	-12.7	239	-22.8
1982	113	-3.2	142	-18.8	596	5.4	206	-13.7
1983	171	50.8	217	52.8	937	57.3	380	84.5
1984	207	20.7	247	13.6	873	-6.8	440	15.7
1985	249	20.8	237	-4.0	785	-10.1	470	6.8
1986	298	19.5	298	25.8	732	-6.8	484	3.0
1987	269	-9.7	308	3.3	633	-13.5	420	-13.1
1988	239	-11.4	272	-11.9	574	-9.3	404	-3.9
1989	179	-24.9	266	-2.1	536	-6.6	396	-2.0
1990	131	-26.8	253	-4.9	479	-10.6	329	-16.9
Quarterly								
1984:1	201	29.4	269	29.1	976	0.8	494	24.2
2	197	-1.8	252	-6.2	922	-5.5	451	-8.7
3	195	-1.4	233	-7.7	825	-10.6	420	-6.9
4	233	19.7	234	0.3	768	-6.8	395	-5.8
1985:1	228	-2.3	222	-4.9	790	2.8	474	20.0
2	260	14.3	243	9.1	765	-3.1	457	-3.6
3	230	-11.7	236	-2.9	755	-1.4	481	5.1
4	280	21.6	248	5.2	830	10.0	467	-2.8
1986:1	315	12.6	294	18.5	809	-2.5	481	2.9
2	290	-7.9	298	1.5	776	-4.1	514	6.9
3	299	3.1	302	1.1	706	-9.0	452	-12.0
4	288	-3.7	300	-0.7	636	-9.9	489	8.1
1987:1	285	-0.9	372	24.1	633	-0.5	471	-3.5
2	273	-4.3	296	-20.3	631	-0.3	412	-12.7
3	265	-3.1	281	-5.1	658	4.3	421	2.3
4	254	-4.2	283	0.7	609	-7.4	377	-10.4
1988:1	278	9.7	235	-17.1	532	-12.6	380	0.6
2	236	-15.1	290	23.4	583	9.5	382	0.5
3	234	-1.1	266	-8.4	578	-0.9	407	6.6
4	206	-12.0	296	11.3	602	4.2	448	10.1
1989:1	211	2.4	283	-4.2	571	-5.1	399	-10.9
2	185	-12.2	250	-11.8	532	-6.8	393	-1.5
3	168	-9.4	256	2.5	531	-0.3	393	0.1
4	161	-4.2	284	10.9	506	-4.7	401	1.9
1990:1	172	7.3	308	8.4	538	6.3	415	3.5
2	122	-29.2	260	-15.8	495	-8.0	327	-21.1
3	114	-6.8	235	-9.5	457	-7.7	325	-0.7
4	134	17.6	232	-1.4	423	-7.4	254	-21.9
1991:1	94	-29.9	231	-0.1	378	-10.6	212	-16.4
2	118	26.3	236	2.0	384	1.4	264	24.5

Note: Quarterly levels are annualized. Simple percent changes are shown.
Quarterly figures may not average to annual figures due to rounding.

New Home Sales

Thousands of Units, Seasonally Adjusted; Percent Change

	U.S.		Northeast		Midwest		South		West	
Annual										
1980	545	-22.5	51	-25.6	81	-27.3	269	-11.1	145	-34.8
1981	436	-20.1	46	-8.4	60	-26.1	218	-18.9	112	-23.1
1982	418	-4.0	47	2.0	48	-20.1	223	2.3	100	-10.0
1983	627	50.0	76	61.1	71	48.9	328	47.0	152	51.7
1984	637	1.5	90	18.8	76	7.0	310	-5.5	161	5.4
1985	691	8.6	110	22.0	82	8.1	325	4.9	174	8.4
1986	746	8.0	134	21.4	95	15.5	320	-1.6	197	13.5
1987	669	-10.4	117	-12.7	97	2.5	269	-16.0	186	-5.9
1988	675	0.9	101	-13.8	98	0.1	271	0.7	206	10.6
1989	650	-3.7	86	-14.6	102	4.6	260	-4.1	202	-1.7
1990	534	-17.8	71	-17.4	89	-12.7	225	-13.5	149	-26.2
Quarterly										
1984:1	676	-1.0	86	12.7	76	0.4	336	-9.1	179	10.7
2	628	-7.1	86	0.8	79	3.9	301	-10.3	162	-9.7
3	616	-1.9	99	15.1	74	-6.3	302	0.3	140	-13.2
4	627	1.8	90	-9.7	75	1.8	301	-0.2	161	14.7
1985:1	666	6.2	100	11.9	85	12.8	320	6.3	160	-0.4
2	673	1.1	104	3.3	79	-7.5	323	0.9	168	4.6
3	723	7.4	117	13.2	84	7.2	333	3.0	189	12.5
4	703	-2.8	119	1.4	81	-4.0	325	-2.5	179	-5.1
1986:1	780	11.0	138	16.2	89	10.3	349	7.4	204	13.8
2	791	1.4	142	2.4	99	10.8	336	-3.5	215	5.4
3	694	-12.3	123	-13.4	90	-8.8	299	-11.2	182	-15.2
4	720	3.7	132	7.6	101	12.2	297	-0.4	189	4.0
1987:1	718	-0.3	126	-4.8	106	4.9	293	-1.3	192	1.6
2	674	-6.1	108	-13.8	100	-6.3	278	-5.1	188	-2.4
3	660	-2.1	118	8.9	87	-12.4	271	-2.6	184	-1.8
4	623	-5.6	115	-2.5	96	10.3	234	-13.8	179	-2.9
1988:1	632	1.4	105	-8.7	96	0.0	255	9.1	176	-1.7
2	697	10.2	111	5.4	94	-2.1	287	12.4	205	16.3
3	695	-0.3	97	-12.0	97	2.5	279	-2.6	221	8.1
4	676	-2.7	90	-7.9	103	6.2	263	-5.7	220	-0.5
1989:1	628	-7.1	102	13.4	103	0.0	237	-9.9	186	-15.6
2	636	1.3	81	-20.3	99	-3.6	257	8.4	198	6.5
3	699	10.0	84	4.1	110	10.8	278	8.2	226	14.3
4	652	-6.8	92	9.1	102	-6.7	260	-6.7	198	-12.7
1990:1	597	-8.4	84	-9.1	95	-7.5	240	-7.4	179	-9.6
2	539	-9.7	79	-6.0	92	-3.2	219	-8.9	150	-15.9
3	523	-3.0	65	-16.9	91	-0.7	229	4.7	137	-8.6
4	470	-10.3	68	4.1	81	-11.4	203	-11.5	119	-13.6
1991:1	464	-1.2	49	-27.9	89	9.9	196	-3.4	132	11.2
2	506	9.1	59	20.4	100	12.4	207	5.6	141	6.6

Note: Quarterly levels are annualized. Simple percent changes are shown. Quarterly figures may not average to annual figures due to rounding.

Existing Home Sales

Thousands of Units, Seasonally Adjusted; Percent Change

	U.S.		Northeast		Midwest		South		West	
Annual										
1980	2,973	-22.3	403	-23.4	806	-24.0	1,092	-19.3	672	-24.2
1981	2,419	-18.6	353	-12.4	632	-21.6	917	-16.0	516	-23.2
1982	1,990	-17.7	354	0.3	490	-22.5	780	-14.9	366	-29.1
1983	2,719	36.6	493	39.3	709	44.7	1,035	32.7	481	31.4
1984	2,868	5.5	511	3.7	755	6.5	1,073	3.7	529	10.0
1985	3,214	12.1	622	21.7	866	14.7	1,172	9.2	554	4.7
1986	3,565	10.9	703	13.1	991	14.4	1,261	7.6	610	10.1
1987	3,526	-1.1	685	-2.6	959	-3.2	1,282	1.7	600	-1.6
1988	3,594	1.9	673	-1.8	929	-3.1	1,350	5.3	642	7.0
1989	3,440	-4.3	589	-12.5	919	-1.1	1,307	-3.2	610	-5.0
1990	3,296	-4.2	522	-11.4	892	-2.9	1,325	1.4	557	-8.7
Quarterly										
1984:1	2,927	4.8	500	0.0	783	10.8	1,103	2.2	540	7.3
2	2,983	1.9	523	4.7	777	-0.9	1,123	1.8	557	3.1
3	2,763	-7.4	510	-2.5	723	-6.9	1,027	-8.6	507	-9.0
4	2,800	1.3	507	-0.7	737	1.8	1,040	1.3	510	0.7
1985:1	2,993	6.9	560	10.5	783	6.3	1,127	8.3	530	3.9
2	3,070	2.6	583	4.2	823	5.1	1,123	-0.3	543	2.5
3	3,370	9.8	657	12.6	933	13.4	1,217	8.3	563	3.7
4	3,423	1.6	683	4.1	930	-0.4	1,227	0.8	580	3.0
1986:1	3,340	-2.4	683	0.0	927	-0.4	1,167	-4.9	557	-4.0
2	3,493	4.6	690	1.0	1,013	9.4	1,213	4.0	583	4.8
3	3,593	2.9	693	0.5	990	-2.3	1,293	6.6	617	5.7
4	3,833	6.7	747	7.7	1,033	4.4	1,377	6.4	680	10.3
1987:1	3,693	-3.7	713	-4.5	1,077	4.2	1,300	-5.6	607	-10.8
2	3,613	-2.2	697	-2.3	977	-9.3	1,317	1.3	623	2.7
3	3,427	-5.2	677	-2.9	900	-7.8	1,263	-4.1	587	-5.9
4	3,333	-2.7	653	-3.4	887	-1.5	1,233	-2.4	567	-3.4
1988:1	3,297	-1.1	643	-1.5	890	0.4	1,207	-2.2	557	-1.8
2	3,600	9.2	683	6.2	933	4.9	1,350	11.9	630	13.2
3	3,630	0.8	673	-1.5	933	0.0	1,360	0.7	660	4.8
4	3,690	1.7	660	-2.0	953	2.1	1,410	3.7	663	0.5
1989:1	3,547	-3.9	627	-5.1	920	-3.5	1,337	-5.2	660	-0.5
2	3,340	-5.8	577	-8.0	890	-3.3	1,267	-5.2	603	-8.6
3	3,443	3.1	590	2.3	947	6.4	1,317	3.9	587	-2.8
4	3,537	2.7	593	0.6	967	2.1	1,360	3.3	617	5.1
1990:1	3,443	-2.6	543	-8.4	943	-2.4	1,350	-0.7	607	-1.6
2	3,363	-2.3	517	-4.9	930	-1.4	1,330	-1.5	583	-3.8
3	3,297	-2.0	530	2.6	907	-2.5	1,310	-1.5	547	-6.3
4	3,117	-5.5	500	-5.7	853	-5.9	1,260	-3.8	497	-9.1
1991:1	3,093	-0.7	483	-3.3	887	3.9	1,227	-2.6	503	1.3
2	3,480	12.5	553	14.5	933	5.3	1,397	13.9	603	19.9

Note: Quarterly levels are annualized. Simple percent changes are shown. Quarterly figures may not average to annual figures due to rounding.

Existing Home Prices

Median Prices; in Dollars

	U.S.		Northeast		Midwest		South		West	
Annual										
1980	62,200	12.0	60,800	14.1	51,900	8.8	58,300	13.9	89,300	15.0
1981	66,400	6.8	63,700	4.8	54,300	4.6	64,400	10.5	96,200	7.7
1982	67,800	2.1	63,500	-0.3	55,100	1.5	67,100	4.2	98,900	2.8
1983	70,300	3.7	72,200	13.7	56,600	2.7	69,200	3.1	94,900	-4.0
1984	72,400	3.0	78,700	9.0	57,100	0.9	71,300	3.0	95,800	0.9
1985	75,500	4.3	88,900	13.0	58,900	3.2	75,200	5.5	95,400	-0.4
1986	80,300	6.4	104,800	17.9	63,500	7.8	78,200	4.0	100,900	5.8
1987	85,600	6.6	133,300	27.2	66,000	3.9	80,400	2.8	113,200	12.2
1988	89,300	4.3	143,000	7.3	68,400	3.6	82,200	2.2	124,900	10.3
1989	93,100	4.3	145,200	1.5	71,300	4.2	84,500	2.8	139,900	12.0
1990	95,500	2.6	141,200	-2.8	74,000	3.8	85,900	1.7	139,600	-0.2
Quarterly										
1984:1	71,300	1.8	75,300	3.8	57,200	3.2	70,100	1.3	96,500	1.8
2	72,700	2.0	77,700	3.2	58,100	1.6	72,000	2.7	96,000	-0.5
3	73,200	0.7	80,100	3.1	57,200	-1.5	72,000	0.0	95,900	-0.1
4	72,000	-1.6	81,700	2.0	55,300	-3.3	70,800	-1.7	94,900	-1.0
1985:1	74,100	2.9	86,300	5.6	58,400	5.6	73,500	3.8	93,500	-1.5
2	75,500	1.9	88,300	2.3	59,400	1.7	75,200	2.3	94,600	1.2
3	76,600	1.5	89,500	1.4	59,400	0.0	76,800	2.1	97,400	3.0
4	75,200	-1.8	91,300	2.0	58,100	-2.2	74,500	-3.0	95,700	-1.7
1986:1	78,100	3.9	98,900	8.3	62,200	7.1	77,400	3.9	95,700	0.0
2	82,000	5.0	106,600	7.8	65,300	5.0	80,400	3.9	101,400	6.0
3	80,700	-1.6	106,000	-0.6	63,600	-2.6	78,200	-2.7	101,600	0.2
4	80,200	-0.6	107,200	1.1	62,400	-1.9	75,900	-2.9	101,500	-0.1
1987:1	84,600	5.5	124,500	16.1	67,000	7.4	80,900	6.6	106,900	5.3
2	86,000	1.7	134,400	8.0	66,400	-0.9	81,600	0.9	111,900	4.7
3	86,800	0.9	138,200	2.8	66,200	-0.3	80,400	-1.5	116,600	4.2
4	85,000	-2.1	134,700	-2.5	64,400	-2.7	79,400	-1.2	116,500	-0.1
1988:1	88,600	4.2	138,300	2.7	67,400	4.7	82,800	4.3	119,400	2.5
2	89,300	0.8	144,100	4.2	68,900	2.2	83,000	0.2	122,600	2.7
3	90,200	1.0	144,900	0.6	68,900	0.0	83,200	0.2	126,800	3.4
4	88,700	-1.7	142,700	-1.5	67,700	-1.7	79,700	-4.2	129,900	2.4
1989:1	91,200	2.8	143,400	0.5	69,400	2.5	84,100	5.5	133,600	2.8
2	93,000	2.0	145,800	1.7	70,900	2.2	84,900	1.0	139,400	4.3
3	94,900	2.0	147,100	0.9	72,500	2.3	85,700	0.9	145,300	4.2
4	92,700	-2.3	144,100	-2.0	71,800	-1.0	82,800	-3.4	140,900	-3.0
1990:1	95,500	3.0	144,900	0.6	73,200	1.9	85,400	3.1	143,400	1.8
2	96,600	1.2	143,500	-1.0	74,600	1.9	86,800	1.6	139,400	-2.8
3	96,600	0.0	141,900	-1.1	75,100	0.7	87,300	0.6	138,200	-0.9
4	92,200	-4.6	134,900	-4.9	72,000	-4.1	83,200	-4.7	137,700	-0.4
1991:1	95,900	4.0	138,900	3.0	76,400	6.1	85,000	2.2	144,700	5.1
2	101,100	5.4	144,200	3.8	77,900	2.0	89,200	4.9	150,100	3.7

Note: Quarterly levels are seasonally adjusted. Simple percent changes are shown. Quarterly figures may not average to annual figures due to rounding.

U.S. Economic Outlook: August 1991

	91.1	91.2	91.3	91.4	92.1	92.2	92.3	92.4	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-2.8	0.4	2.4	2.9	3.1	3.4	3.8	2.6	2.5	1.0	-0.2	2.9	2.8
Industrial Production	-9.6	1.6	5.0	5.1	5.1	6.6	7.7	6.2	2.6	1.0	-1.9	5.6	5.5
Civilian Employment	-2.4	0.3	1.2	1.3	1.5	1.7	1.9	1.7	2.0	0.5	-0.6	1.5	1.5
GNP Inflation Index	5.2	3.9	3.9	3.3	3.4	2.7	3.0	2.9	4.1	4.1	4.0	3.3	3.1
Consumer Prices	3.5	2.1	3.4	3.4	3.5	3.6	4.2	3.9	4.8	5.4	4.3	3.5	3.9
Value of the U.S. Dollar	8.0	45.9	2.9	-1.9	-0.2	-0.3	-0.1	-0.6	6.2	-9.6	2.3	2.1	-0.2
Percent													
Mfg. Capacity Utilization	78.0	77.8	78.2	79.1	79.8	80.9	82.2	83.2	84.0	82.3	78.3	81.5	85.0
Civilian Unemployment	6.5	6.8	6.8	6.8	6.7	6.4	6.1	5.9	5.3	5.5	6.7	6.3	5.7
Percent of GNP													
Federal Tax Receipts	20.4	20.4	20.4	20.5	20.6	20.6	20.6	20.5	20.2	20.3	20.4	20.6	20.5
Federal Expenditures	22.7	23.5	23.4	23.9	24.1	23.8	23.5	23.3	22.8	23.3	23.4	23.7	23.1
Federal Budget Deficit	-2.3	-3.1	-3.0	-3.4	-3.4	-3.2	-2.9	-2.8	-2.6	-3.0	-3.0	-3.1	-2.5
Interest Rates, Percent													
Federal Funds Rate	6.4	5.9	5.6	5.5	5.7	6.0	6.2	6.1	9.2	8.1	5.8	6.0	6.0
3-Month T-Bill Rate	6.0	5.6	5.5	5.3	5.4	5.5	5.7	5.7	8.1	7.5	5.6	5.6	5.6
Prime Rate	9.2	8.7	8.5	8.3	8.5	8.6	8.7	8.7	10.9	10.0	8.7	8.6	8.7
Discount Rate	6.2	5.7	5.5	5.5	5.5	5.6	5.7	5.8	6.9	7.0	5.7	5.7	5.7
Corporate AAA Bond Yield	8.9	8.9	8.9	8.8	8.6	8.5	8.5	8.4	9.3	9.3	8.9	8.5	8.1
30-Year Government Bond Yield	8.2	8.3	6.3	8.2	8.1	8.0	8.0	8.0	8.4	8.6	8.3	8.0	7.7
Mortgage Rates, Percent													
30-Year Fixed Rate	9.5	9.5	9.3	9.2	9.1	9.1	9.0	9.0	10.3	10.1	9.4	9.1	8.8
1-Year Adjustable	8.1	7.6	7.3	7.2	7.1	7.0	7.0	7.0	9.3	8.4	7.3	7.0	7.0
Home Sales & Starts													
Thousands													
Total Single-Family Sales*	3,798	4,290	4,393	4,423	4,452	4,511	4,541	4,559	4,413	4,164	4,226	4,516	4,626
Existing Single-Family Sales	3,093	3,480	3,493	3,522	3,541	3,565	3,591	3,607	3,440	3,296	3,397	3,576	3,663
New Single-Family Sales	464	506	518	530	546	565	572	584	650	534	504	566	609
Housing Starts	915	1,002	1,131	1,185	1,200	1,243	1,253	1,261	1,376	1,193	1,058	1,239	1,303
Single-Family Units	726	835	928	929	939	976	979	981	1,003	895	854	969	992
Multi-Family Units	189	167	203	256	261	267	274	280	373	298	204	270	311
2-4 Family Units	31	31	37	46	45	45	45	44	55	38	36	45	45
5+ Family Units	158	136	166	211	216	222	229	236	318	260	168	226	266
Mobile Homes Shipped	161	176	208	222	231	244	247	245	199	188	192	242	240
Percent change -- Year Ago													
Total Single-Family Sales	-15.2	1.4	6.4	14.0	17.2	5.2	3.4	3.1	-4.4	-5.9	1.1	6.9	2.4
Existing Single-Family Sales	-10.2	3.5	5.9	13.0	14.5	2.4	2.8	2.4	-3.6	-4.7	3.1	5.3	2.4
New Single-Family Sales	-22.3	-6.1	-1.1	12.7	17.6	11.5	10.4	10.3	-3.3	-18.5	-5.5	12.3	7.4
Housing Starts	-36.1	-16.8	0.0	13.7	31.1	24.0	10.8	6.4	-7.5	-13.3	-11.3	17.1	5.2
Single-Family Units	-31.8	-6.8	8.4	18.1	29.4	16.8	5.5	5.6	-7.3	-10.8	-4.5	13.4	2.4
Multi-Family Units	-48.7	-45.8	-26.0	0.2	37.7	60.0	34.8	9.2	-8.0	-20.1	-31.5	32.6	15.1
2-4 Family Units	-27.1	-27.7	15.9	46.9	43.6	42.9	20.1	-3.1	-5.8	-32.1	-3.1	22.8	1.3
5+ Family Units	-51.5	-48.7	-31.5	-6.3	36.5	63.9	38.1	11.9	-8.3	-18.0	-35.6	34.7	17.8
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	95.9	101.1	103.0	103.3	103.8	104.7	105.6	106.4	93.1	95.5	100.8	105.1	109.7
New Home Prices	120.2	119.3	120.5	123.0	125.2	126.0	128.0	129.3	120.0	122.9	120.7	127.1	132.7
Percent Change - Year Ago													
Existing Home Prices	0.5	4.7	6.7	12.0	8.2	3.6	2.5	3.0	4.4	2.6	5.9	4.3	4.4
New Home Prices	-2.9	-5.8	3.2	0.8	4.1	5.7	6.2	5.1	5.9	2.4	-1.3	5.3	4.4

Quarterly figures are seasonally adjusted annual rates.

* Total single-family sales equals single-family resales plus 97% of single-family housing starts.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of the current condition of the U.S. economy, easy-to-read forecasts for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets.

If you would like to subscribe to the *Real Estate Outlook,* contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

Editorial questions can be directed to Robert Barr at (202) 383-7525.

REALTOR®

EQUAL HOUSING
OPPORTUNITY

A [illegible] 1

Real Estate

OUTLOOK

September 1991

The sustainability of the budding recovery has been called into question by the mixed signals from the monthly economic indicators. August's decline in personal income and the steady erosion of consumer confidence hint at a return to recession, while the 11% gain in durable goods orders, a string of increases in industrial production and lower inflation suggest a healthy recovery. NAR projects that the economy will muddle through the remainder of the year before staging a robust recovery beginning early next year. *Page 2*

Housing starts continued their ascent in July, increasing 3.7% to an annual rate of 1.07 million units. July's figure is the highest since November of 1990, but starts remain 7.4% below the figure recorded one year ago. Building activity in the South accounted for much of the increase in July. There, starts increased 15.2% to 448,000 units. *Page 4*

After increasing for five consecutive months, the rate of existing home sales reversed its course in July. Sales dropped 6.7% from June's resale rate of 3.59 million units. Now that some of the demand that had been pent-up since last fall has been filled, existing home sales are expected to return to a more sustainable course of growth. *Page 6*

Also In This Issue:

Fear Strikes Out (Looking)	*Economic Commentary* *by John A. Tuccillo*	*Page 1*
Outlook for the Economy & Real Estate	*Robert D. Barr* *& Kimberly A. Martin*	*Pages 2-9*
Introducing the Construction Data	*Robert D. Barr* *& Jason B. Guesman*	*Pages 10-11*

NATIONAL ASSOCIATION OF REALTORS®
REALTOR® *The Voice for Real Estate*™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991
NATIONAL ASSOCIATION OF REALTORS®

Fear Strikes Out (Looking)

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

The power of ideas. Christ and Mohammed transformed the world with them. Jefferson created the most powerful political movement in history with his. And two centuries ago, Adam Smith put together a collection of ideas that last month caused hell to freeze over. For the first time in their thousand year history, the peoples of the Soviet Union were told by their leaders to do something and they refused, because the power of the ideas of free markets and democracy were stronger than their fears.

In retrospect, it was no contest: a badly planned coup by the gray-haired and gray-faced leaders of a government where mismanagement is a culture. It was Boris Yeltsin against Boris Badanov. But when the popguns of August went down, they were defeated by a people who had seen how freedom works and were not going back.

It's easy to analogize the current state of the Soviet Union to that of the American colonies in 1781. Here are a number of newly independent states, freed from the tyranny of statist oppression, ready to burst forth as capitalist democracies.

But it's far from the same. Unlike the American colonies, Russia and the Baltic States and the Ukraine have no traditions of either democracy or capitalism on which to build. Rather, they are inspired by ideas and now need to invent the institutions and processes that will make those ideas real in their lives. Their reality is that of the Third World.

Right now, the Soviet economy is bankrupt and facing a potential winter disaster. So the calls for aid from the developed world followed right on the heels of the departing tanks. The West should respond immediately, despite the threat (so pointedly noted by the Wall Street Journal) that aid now would only prop up Gorbachev without forcing him to commit to reform.

But, remembering the difference between giving fish and teaching how to fish, the longer term challenge is to provide the technical assistance that will enable the creation of free market institutions and systems. This builds a capacity to absorb the American investment now so hotly debated, and ultimately will feed back into the U.S. economy in the form of strong demand for American goods.

Clearly, the whole thing can turn around in a day, and the hardliners can make yet another *putsch*. But it's not likely. The drive for reform and free markets is too strong, and even though they will come slowly and grudgingly, they will come. The great issue of whether the events of August will speed reform in the Soviet Union seems to have been decided in the affirmative.

Interestingly, few are raising an equally telling issue: Will the events of August speed reforms in the United States? We have lived for centuries guided by the ideas that are now lighting flames in the East, just as they have inspired other nations. Yet, we seem to have forgotten a great many of them. And when we forget the roots from which we spring, we manage to create the Charles Keatings and the BCCIs of the world.

Capitalism promises great rewards, but also carries great risks. Our economy was shaped by a process of success and failure that are equal sides of the capitalist coin. Yet, now we talk about banks that are "too big to fail" and social insurance systems that protect all people and businesses against all mistakes.

Capitalism requires markets in which the price mechanism is free to operate and in which entry and exit are relatively easy. Yet, our system now seems to regulate everything from automobile components to the distance between door frame and window sill in a new house.

Capitalism requires a continual infusion of new resources and ideas through the process of investment, so that the surplus it creates can be used to build future earnings. Yet, we now live in an economy which in its public policies discourages all forms of investment, and especially its most productive, that in real estate.

Capitalism requires a political system in which power flows to wealth (and this may be the hardest of all lessons for the Soviets to learn), not the reverse. Yet, in our government of constant campaigning, power is independent of wealth and, in a highly regulated society, seems to attract it.

Cataclysmic events cause humans to take stock, so funerals and weddings are usually the occasion for much soul searching. The disintegration of the Soviet empire and the coming (we hope) democratic future should likewise cause us to examine our own society, and the degree to which it has strayed from the ideal of free market democracy.

If the movement to a Soviet market economy is to have a motto, there are few better than the words of Albert Einstein:

> *Everything that is really great and inspiring is*
> *created by the individual who can labor in freedom.*

All the ideas that matter -- individual, labor, freedom -- are there. Every now and again we need to remember just how powerful they can be.

Outlook for the Economy

The sustainability of the budding recovery has been called into question by recent economic reports, some of which suggest that the recession may still be lingering. The mixed signals from the monthly economic indicators highlight the economy's current transitional nature, but just where we're headed remains unclear. August's decline in personal income and the steady erosion of consumer confidence suggest a return to recession, while the 11% gain in durable goods orders, a string of increases in industrial production and lower inflation suggest a normal, healthy recovery. Meanwhile, the anemic employment gains indicate that the recovery will remained hobbled.

While noting the possibility of another recessionary dip in production, NAR projects that the economy will muddle through the remainder of the year before staging a robust recovery beginning early next year. After nine months of decline, output in the third quarter is projected to expand at a 2.9% annual rate, the fastest rate since early 1989. The composition of that growth -- powered by inventory rebuilding, not increasing demand -- means that the recovery is relying on a temporary boost for its health. Consequently, growth is expected to slide down a notch to 2.3% in the year's final quarter. The year is expected to post a 0.3% decline, and a 2.5% rebound is projected for 1992.

Missing in Action: Persistent Demand Gains

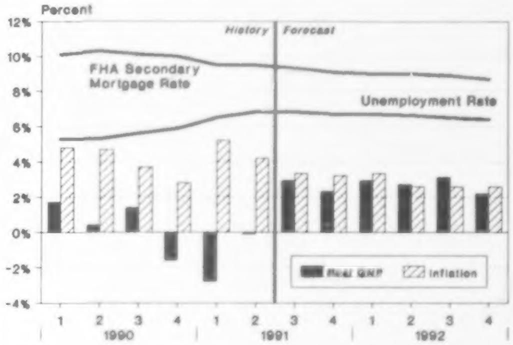
Feeling relief over the end of seven months of Persian Gulf tension, consumers jump-started the economy last spring. Sales of both new and existing homes rose sharply, and spending on consumer goods bounced back. The growth in spending was answered largely by a liquidation of inventories, while businesses, concerned about rising debt levels and credit availability, waited to see if the renewed strength in spending would last before stepping up production. Now, it appears, just as businesses are gearing up again, consumer enthusiasm is on the wane.

Consequently, growth in the third quarter is expected to come from a source that won't provide much long-term relief: replenishing drawn-down inventories. All of the economy's production -- its GNP -- can be broken down into two parts: that which is sold (final demand) and that which is stored and sold later (changes in inventories). The bulk of the economy's growth in the third quarter will come from the additions to inventories, accounting for 2.4 percentage points of the total 2.9% increase. The remaining 0.5 percentage points will be demand's meager contribution.

The implication is this: If demand remains sluggish, then once the stocks are replenished, production schedules may again be pared down. For the recovery to be sustained beyond year-end, other sectors of the economy will need to step forward and provide the necessary stimulus. Government spending is constrained by deficits on the federal, state, and local levels. Exports will continue to provide some help, but that will likely diminish in the face of the dollar's recent appreciation. Businesses are projected to boost equipment spending, but this accounts for less than 10% of the economy's total production.

As usual, then, it will be up to the consumer. Because consumption spending accounts for two-thirds of the total

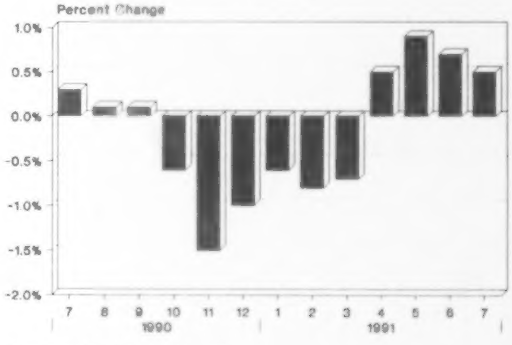
The Economic Outlook



Sources: BEA, BLS, FHLMC, NAR forecast

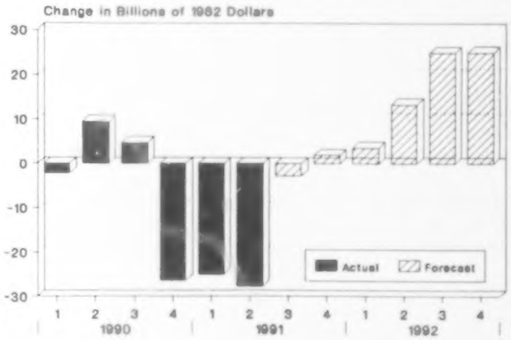
Industrial Production Recovers

But Slack Demand May Lead to Smaller Increases



Source: Federal Reserve Board

Inventory Liquidation in First Half Sets Stage for Growth



Source: Bureau of Economic Analysis; NAR forecast

GNP, the economy usually steps to the beat of the consumer's drum, and recently the rhythm has been fading. The consumer confidence index has fallen in four of the past five months, an omen of lethargic consumption growth in the months ahead. The fundamentals behind household spending -- income and employment -- have shown only weak growth in the past few months. It's for these reasons that we believe the recovery will remain tepid.

Job Gains Point to Subdued Recovery

The chart at right shows how the character of the monthly change in employment has improved since April. The declines recorded in June and July were very modest, especially relative to the losses racked up between last October and April. While May's and August's figures were up, they fell short of the average gain recorded during the last economic expansion.

Manufacturing has been hit hard, and not just by the recession. Production had been on the skids for more than a year before the official start of the recession in July 1990. In fact, manufacturing employment has grown in only five of the 32 months since the beginning of 1989. Three of those five months have come since May, signaling that a turnaround is finally in the works. In August, 42,000 workers returned to manufacturing payrolls.

Continued Good News on the Inflation Front

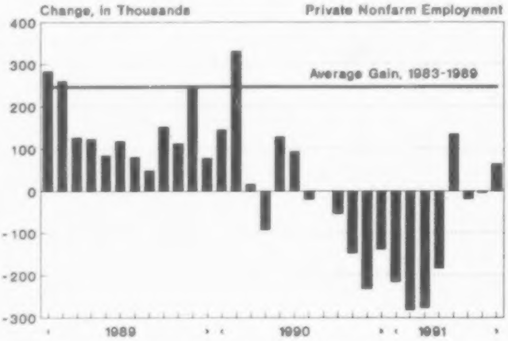
After sharp increases related to last fall's rising energy prices, the inflation rate has continued to moderate. The unwinding of oil prices and the weak economy have limited the increase in consumer prices to just a 2.7% annual rate since last December. The core rate of consumer inflation, defined as the total Consumer Price Index less its volatile energy and food components, rose 4.8% in the twelve months ending in July. This is a significant decrease from the 5.6% rate measured over the twelve months ending last February. As the chart shows, the monthly reports on producer prices have been positive as well, with two declines registered in the past two months.

One hurdle to the recovery has been lowered significantly. Long-term interest rates broke in mid-August, with rates on conventional 30-year mortgages falling almost a third of a point during the month. As the chart shows, rates drifted up during the spring and early summer, but tumbled in August with the growing realization that the recovery was sluggish and inflation was under control. Still, given the recent inflation performance, long-term interest rates remain high. This apparently reflects the fear that the Federal Reserve, in order to revive the recovery, may pump up the economy too fast and introduce additional inflation.

The Fed, for its part, is at a critical juncture. It is well aware that the most serious errors committed by previous Fed boards have come after the economy has turned the corner but before that turn is evident. Hindsight shows that too much stimulus was provided during this period, resulting in extra inflation. Adding to the dilemma are today's banking problems, such as the credit crunch, which make the usual monetary compasses less reliable. The forecast assumes a further easing in the next month, as the Fed cuts its discount rate a half-point to 5.0%.

Employment On The Mend

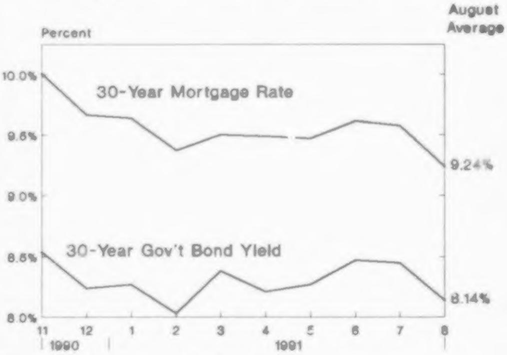
Steep Declines Over, But Recent Gains Weak



Source: Bureau of Labor Statistics

Long-Term Rates Fall in August

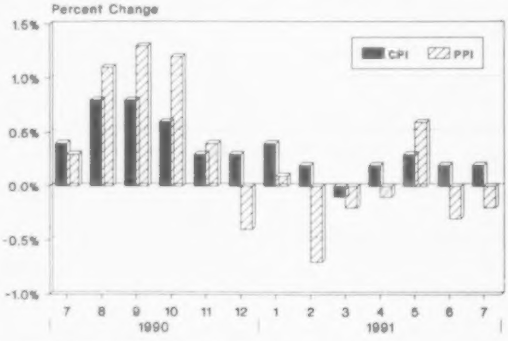
Mortgage Rates at Their Lowest Since February



Source: Federal Reserve Board

Inflation Winding Down

Recent Reports May Give Fed Room To Ease Further



Source: Bureau of Labor Statistics

Housing Starts

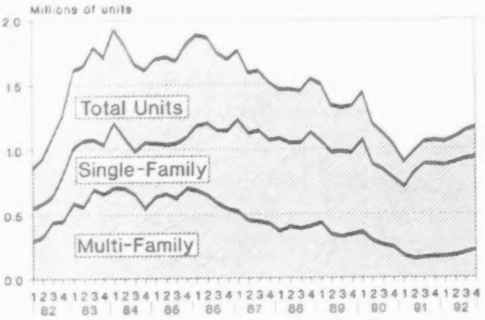
National Data

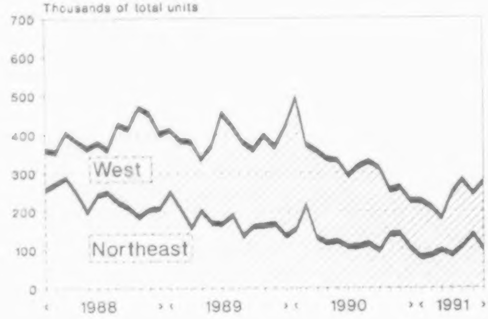
	Total	SF	MF:2-4	MF:5+
Jul 1990	1,155	876	31	248
Feb 1991	992	788	37	167
Mar 1991	907	742	28	137
Apr 1991	977	801	32	144
May 1991	983	831	36	116
Jun 1991	1,032	862	26	144
Jul 1991	***1,070***	***894***	***48***	***128***
Annual Averages:				
1989	1,381	1,005	56	320
1990	1,203	901	37	265
Percent Changes in July 1991 since:				
Jul 1990	-7.4	2.1	54.8	-48.4
Jun 1991	3.7	3.7	84.6	-11.1

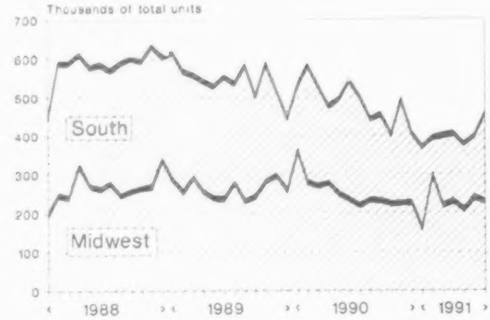
Regional Data

	Northeast	Midwest	South	West
Jul 1990	115	226	492	322
Feb 1991	91	301	384	216
Mar 1991	104	226	390	187
Apr 1991	93	236	395	253
May 1991	114	216	367	286
Jun 1991	145	246	389	252
Jul 1991	***106***	***235***	***448***	***281***
Annual Averages:				
1989	181	269	535	397
1990	135	259	478	330
Percent Changes in July 1991 since:				
Jul 1990	-7.8	4.0	-8.9	-12.7
Jun 1991	-26.9	-4.5	15.2	11.5

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







Housing starts continued their ascent in July, increasing 3.7% to an annual rate of 1.07 million units. July's figure is the highest since November of 1990, but starts remain 7.4% below the figure recorded one year ago.

Continued gains in housing starts are evidence of the growing recovery in the residential construction market. Starts of single-family homes increased 3.7% to an annual rate of 894,000 units. Starts of multifamily homes recorded an overall increase of 3.5% in July, but the performance of the individual categories of multifamily homes was mixed. The construction of homes with 2 to 4 units surged 84.6% to 48,000 units, while the construction of homes with 5 or more units declined 11.1% to 128,000 units.

Building activity in the South accounted for much of the increase in July. After rising 6.0% in June, starts increased another 15.2% in July, bringing the annual rate to 448,000 units. Starts also advanced in the West, with an increase of 11.5% to 281,000 units. After an impressive performance during the second quarter, starts in the Northeast decreased a disappointing 26.9% in July. A decline of 4.5% in the Midwest brought the rate of starts down to 235,000 units.

Housing starts should average 1.08 million units during the second half of this year. Falling mortgage rates accompanied by a looser lending environment will fuel housing construction in 1992. Total starts will post a healthy 11.0% gain over 1991, with multifamily starts leading the rally. The construction of multifamily homes will increase 15.1% in 1992, while single-family starts are expected to increase 10.1%.

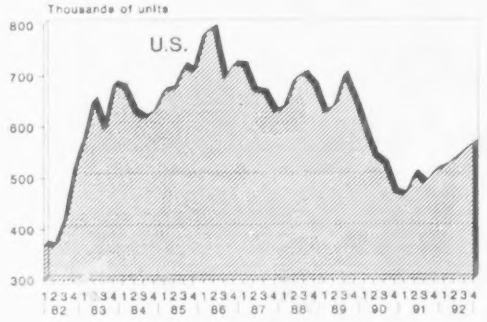
National Data

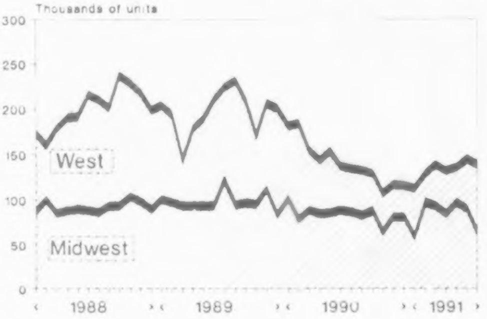
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jul 1990	541	-1.5	-27.0
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	414	-10.8	-34.0
Feb 1991	488	17.9	-19.5
Mar 1991	495	1.4	-11.4
Apr 1991	506	2.2	-5.2
May 1991	496	-2.0	-7.1
Jun 1991	516	4.0	-6.0
Jul 1991	***472***	***-8.5***	***-12.8***
Annual Averages:			
1989	654		-3.3
1990	534		-18.3

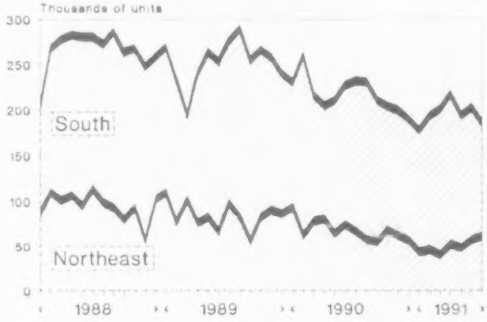
Regional Data

	Northeast	Midwest	South	West
Jul 1990	72	92	237	140
Feb 1991	52	102	199	134
Mar 1991	46	99	206	144
Apr 1991	58	90	222	137
May 1991	54	102	199	141
Jun 1991	63	95	208	150
Jul 1991	***67***	***69***	***191***	***144***
Annual Averages:				
1989	90	103	258	202
1990	75	90	222	147
Percent Changes in July1991 since:				
Jul 1990	-6.9	-25.0	-19.4	2.9
Jun 1991	6.3	-27.4	-8.2	-4.0

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







New home sales fell below the half-million mark in July. The annual rate of sales stood at 472,000 units, which is 8.5% below June's rate and the lowest level since January of 1991. The upward drift in mortgage rates in the spring and the end of the release of the demand that had been pent-up since last fall are likely the causes of July's decline in sales.

Of the four Census reporting regions, the Northeast was the only region to record a gain in July. After increasing nearly 17.0% in June, sales climbed another 6.3% in July to 67,000 units. Although this figure remains 6.9% below the sales rate of one year ago, the latest monthly increases indicate that recovery is proceeding in the region that was hardest hit by the recession.

Of the remaining three regions, the Midwest encountered the greatest losses in July, decreasing 27.4% to 69,000 units. In the South, sales dropped 8.2% to 191,00 units. Sales also faltered in the West, falling 4.0% to 144,000 units. Even with this decline, sales remain 2.9% above the figure one year ago.

According to the NAR forecast, the rate of new home sales will average 499,000 units during the latter half of 1991. During the first half of 1992, the pace of sales is expected to accelerate, averaging 527,000 units. Additional gains are expected for the remainder of 1992, and for the entire year sales are expected to post a 10.1% gain over 1991.

Lower mortgage rates will continue to stimulate sales into 1993. Overall, the rate of new home sales is forecast to increase a robust 9.4% to an annual rate of 593,000 units in 1993.

Existing Home Sales

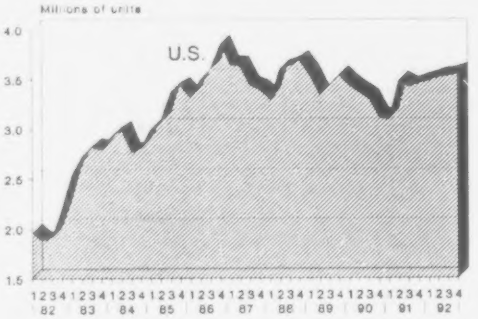
National Data

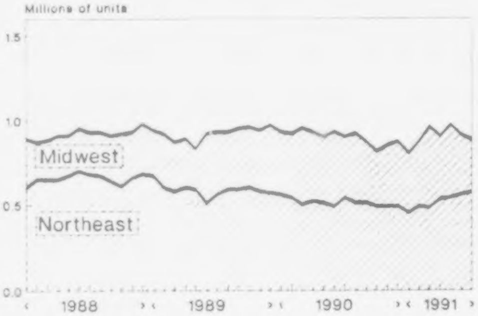
		Mo. Ago % Chg.	Yr. Ago % Chg.
Jul 1990	3,320	-1.5	-1.8
Aug 1990	3,410	2.7	-1.8
Sep 1990	3,160	-7.3	-0.9
Oct 1990	3,070	-2.8	-10.0
Nov 1990	3,150	2.6	-12.0
Dec 1990	3,130	-0.6	-11.5
Jan 1991	2,900	-7.3	-12.1
Feb 1991	3,160	9.0	-16.4
Mar 1991	3,220	1.9	-7.6
Apr 1991	3,310	2.8	-6.4
May 1991	3,540	6.9	-1.8
Jun 1991	3,590	1.4	5.7
Jul 1991	***3,350***	***-6.7***	***6.5***
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

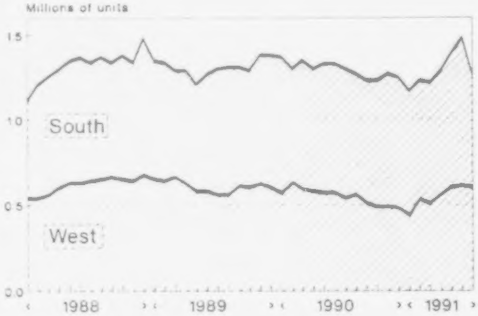
Regional Data

	Northeast	Midwest	South	West
Jul 1990	550	910	1,310	550
Feb 1991	500	880	1,240	540
Mar 1991	490	970	1,230	520
Apr 1991	540	910	1,300	570
May 1991	550	980	1,400	610
Jun 1991	570	920	1,490	620
Jul 1991	***580***	***890***	***1,270***	***610***
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in July 1991 since:				
Jul 1990	5.5	-2.2	-3.1	10.9
Jun 1991	1.8	-3.3	-14.8	-1.6

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors, 'Home Sales'







After increasing for five consecutive months, the rate of existing home sales reversed its course in July. The resale rate dropped 6.7% to 3.35 million units. Despite the decline, July's figure remains 6.5% above the rate of one year ago. The surge of activity that occurred during the last few months reflected renewed consumer optimism at the close of the Gulf War and a desire to take advantage of low mortgage rates. Now that some of the pent-up demand has been filled, the market is expected to return to a more sustainable course of growth.

Of the four Census reporting regions, the Northeast was the only region to post a gain in resales during July. There, sales increased 1.8% to an annual rate of 580,000 units. Of the remaining three regions, the South saw the biggest decline in July, as sales decreased 14.8% from June's rate of 1.5 million units. Sales also edged down in the Midwestern and Western regions. The Midwest experienced a 3.3% decline in the sales rate to 890,000 units, while the West saw sales drop off 1.6% to 610,000 units.

By year end the resale rate is expected to stand at 3.46 million units. As a result of the robust activity during the spring of this year, sales should average 3.36 million units in 1991, which translates into a 2.1% gain over 1990's rate.

The momentum established in 1991 will position the resale market for stable growth in 1992 and 1993. In 1992, sales are projected to increase 4.7% to an annual rate of 3.52 million units. In 1993, the rate of existing home sales will continue to increase, but at the slower pace of 2.8%.

Prices of New & Existing Homes

National Data

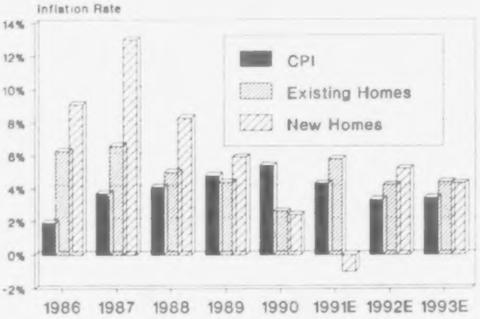
	Median		Average	
	Existing	New	Existing	New
Jul 1990	98,100	118,700	121,100	149,800
Feb 1991	94,000	119,900	119,700	147,800
Mar 1991	98,200	122,500	125,200	156,400
Apr 1991	100,300	121,000	128,900	150,800
May 1991	101,100	118,000	130,600	147,400
Jun 1991	102,000	121,100	130,500	147,000
Jul 1991	***103,000***	***120,200***	***131,600***	***151,000***
Annual Averages:				
1989	93,100	120,400	118,100	148,300
1990	95,500	122,300	118,600	149,100
Percent changes in July 1991 since:				
Jul 1990	5.0	1.3	8.7	0.8
Jun 1991	1.0	-0.7	0.8	2.7

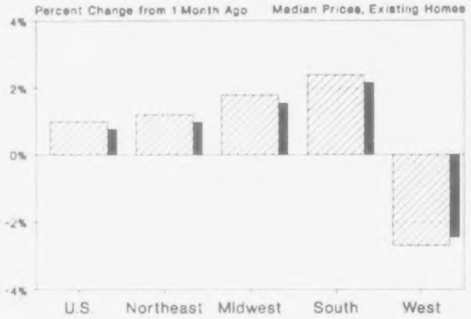
Regional Data

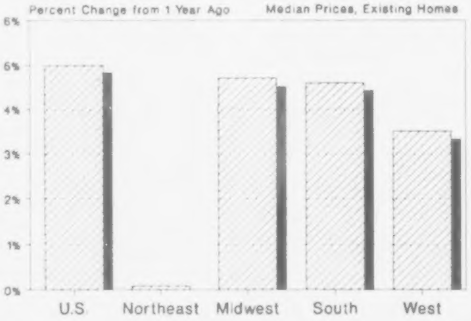
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Jul 1990	143,300	76,100	88,800	139,700
Feb 1991	137,200	76,400	83,200	137,100
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	144,800	77,900	88,000	151,000
May 1991	144,900	77,500	88,900	152,100
Jun 1991	141,800	78,300	90,700	148,600
Jul 1991	***143,500***	***79,700***	***92,900***	***144,600***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in July 1991 since:				
Jul 1990	0.1	4.7	4.6	3.5
Jun 1991	1.2	1.8	2.4	-2.7

Levels are shown in dollars.
Source: National Association of Realtors, 'Home Sales'







Since March of 1991, the median price of existing single-family homes appreciated 9.6%, or $9,000. Home sellers were under less pressure to lower prices this spring, as the close of the Persian Gulf war and lower mortgage rates rekindled the demand for homes.

Meanwhile, in the market for new homes, the median price partially reversed June's 2.6% increase with a 0.7% decrease in July. It now stands at $120,200, up 1.3% from the median price one year ago.

The average price of existing homes increased 0.8% in July to $131,600. When compared with July of 1990, the average price has risen 8.7%.

On a regional basis, the West was the only region which did not record an increase in the median price of existing homes in July. There, the median price dropped 2.7% from June's figure of $148,600. Each of the remaining regions experienced price increases in July. In the South, the median price increased 2.4% to $92,900. The Midwest experienced a comparable increase of 1.8% to $79,700, while the price in the Northeast edged up 1.2% to $143,500.

In contrast to the first half of 1991, the median price of existing homes will appreciate modestly during the second half, leaving 1991 with an overall 5.8% gain to $100,700. In 1992 and 1993, the median price will continue to rise, increasing 4.2% and 4.4%, respectively. The median price of new single-family homes is expected to fall 1.0% in 1991. By 1992, however, prices are expected to appreciate with renewed force, and the median price is projected to increase 5.2% to $127,400. Prices will continue to firm in 1993, increasing 4.3% to $132,900.

Construction

Value of Construction Put in Place

Total

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Jul 1990	406.9	0.1	0.3
Aug 1990	403.0	-1.0	-1.5
Sep 1990	393.3	-2.4	-4.4
Oct 1990	391.2	-0.5	-3.8
Nov 1990	388.8	-0.6	-5.6
Dec 1990	380.6	-2.1	-6.4
Jan 1991	366.5	-3.7	-11.8
Feb 1991	369.3	0.8	-12.6
Mar 1991	362.0	-2.0	-13.9
Apr 1991	364.2	0.6	-11.5
May 1991	357.2	-1.9	-12.4
Jun 1991	355.5	-0.5	-12.5
Jul 1991	***358.9***	***1.0***	***-11.8***

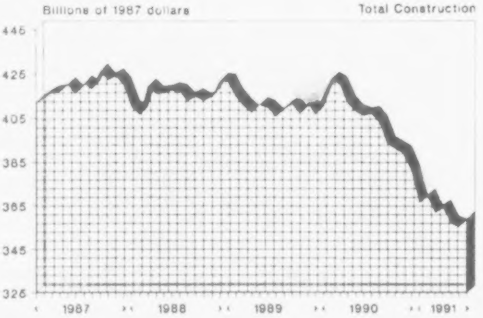
Single-Family Housing

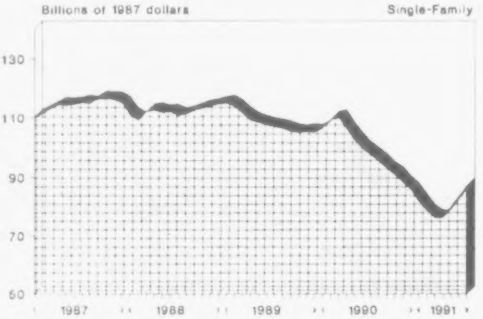
	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Jul 1990	97.3	-2.1	-9.0
Aug 1990	95.3	-2.1	-10.4
Sep 1990	92.8	-2.6	-11.9
Oct 1990	90.9	-2.0	-13.4
Nov 1990	88.0	-3.2	-16.4
Dec 1990	85.7	-2.6	-18.5
Jan 1991	81.8	-4.6	-23.2
Feb 1991	78.6	-3.9	-28.2
Mar 1991	76.3	-2.9	-30.6
Apr 1991	76.4	0.1	-27.9
May 1991	79.9	4.6	-21.9
Jun 1991	83.4	4.4	-16.1
Jul 1991	***87.2***	***4.6***	***-10.4***

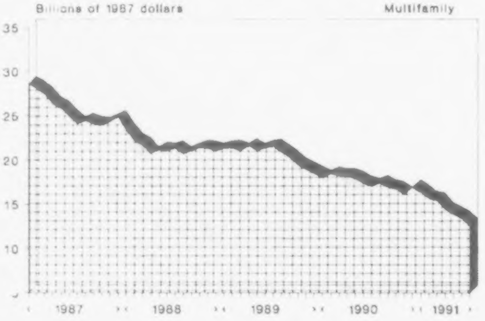
Multifamily Housing

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Jul 1990	17.1	-1.2	-20.5
Aug 1990	17.4	1.8	-16.7
Sep 1990	16.9	-2.9	-16.7
Oct 1990	16.7	-1.2	-13.9
Nov 1990	16.1	-3.6	-15.3
Dec 1990	16.9	5.0	-8.6
Jan 1991	16.3	-3.6	-9.4
Feb 1991	15.6	-4.3	-15.2
Mar 1991	15.4	-1.3	-15.4
Apr 1991	14.4	-6.5	-20.9
May 1991	13.9	-3.5	-22.3
Jun 1991	13.4	-3.6	-22.5
Jul 1991	***12.5***	***-6.7***	***-26.9***

Levels are seasonally adjusted billions of 1987 dollars.
Source: Bureau of the Census







The total value of construction put in place increased 1.0% in July to $358.9 billion, ending a two-month 2.6% slide. In the year since the current slide began, total construction has fallen almost 12%.

In the residential sector, the value of single-family housing construction increased 4.6%, while the value of multifamily housing construction declined 6.7%. The 14.1% gain recorded in single-family construction during the past three months reflects the recent strength in single-family housing starts, and the 20% increase in starts since March indicates that this figure will be rising over the next several months. In spite of this recent spurt of activity, the figure remains 10.4% below its level of a year ago.

Value of Construction Put in Place

Offices

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Jul 1990	24.5	12.9	30.3
Aug 1990	20.5	-16.3	3.0
Sep 1990	20.3	-1.0	-1.5
Oct 1990	20.5	1.0	3.0
Nov 1990	20.2	-1.5	2.0
Dec 1990	20.7	2.5	8.9
Jan 1991	20.2	-2.4	-3.8
Feb 1991	20.9	3.5	-9.1
Mar 1991	20.7	-1.0	-7.6
Apr 1991	21.8	5.3	-0.5
May 1991	18.4	-15.6	-16.4
Jun 1991	18.7	1.6	-13.8
Jul 1991	***19.5***	***4.3***	***-20.4***

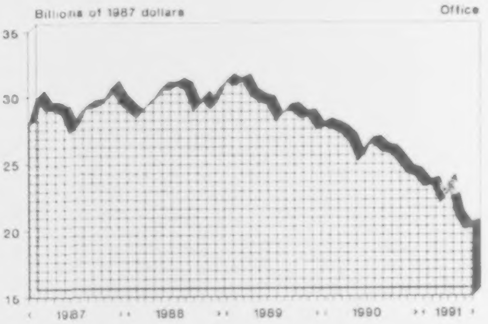
Industrial

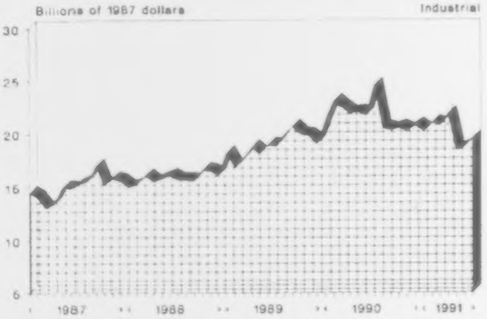
	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Jul 1990	26.4	0.4	-6.0
Aug 1990	25.8	-2.3	-10.4
Sep 1990	25.7	-0.4	-11.1
Oct 1990	25.0	-2.7	-11.7
Nov 1990	24.2	-3.2	-14.8
Dec 1990	24.0	-0.8	-12.7
Jan 1991	23.2	-3.3	-16.2
Feb 1991	23.3	0.4	-15.3
Mar 1991	22.0	-5.6	-19.1
Apr 1991	23.5	6.8	-11.7
May 1991	20.9	-11.1	-16.7
Jun 1991	20.0	-4.3	-24.0
Jul 1991	***20.2***	***1.0***	***-23.5***

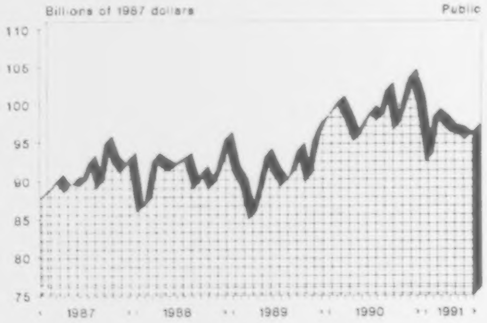
Public

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Jul 1990	97.8	-1.0	9.5
Aug 1990	101.8	4.1	12.4
Sep 1990	96.6	-5.1	2.9
Oct 1990	99.9	3.4	11.1
Nov 1990	103.6	3.7	8.8
Dec 1990	100.0	-3.5	2.5
Jan 1991	92.5	-7.5	-6.2
Feb 1991	98.4	6.4	-1.7
Mar 1991	97.5	-0.9	-0.4
Apr 1991	96.3	-1.2	1.3
May 1991	96.1	-0.2	-1.1
Jun 1991	95.3	-0.8	-3.5
Jul 1991	***96.4***	***1.2***	***-1.4***

Levels are seasonally adjusted billions of 1987 dollars.
Source: Bureau of the Census







For the first time in over a year, office construction posted back-to-back monthly gains in July, adding 4.3% to stand at $19.5 billion. This level of construction spending is only four-fifths of its level of a year ago. Problems with the availibility of financing and the swollen supply of unleased office space will limit the gains in this category over the next year or so.

Tight finances at the federal, state, and local levels of government will keep the lid on public construction, which broke a string of four consecutive monthly declines by gaining 1.2% in July.

Robert D. Barr
Director of Forecasting

Kimberly A. Martin
Research Economist

Forecasting & Policy Analysis

Introducing the Construction Data

Notes about the series presented on pages 8 &9

This month's *Real Estate Outlook* introduces two new pages of monthly construction data that will be updated in every issue of the *Outlook*. The tables and charts show the total figure and five major components: single-family housing, multifamily housing, office buildings, industrial buildings, and public construction. The data covers the entire U.S.

This set of data is a strong indicator of how many and how quickly construction starts are translating into actual structures. Instead of measuring total contract awards or the number of housing starts, which emphasize imminent rather than current economic activity, this data measures the value of the construction that has actually been completed, or "put in place," during the month. Thus, projects which appear as housing starts in one month eventually impact construction put in place data over several months as work on the projected is completed.

Definitions

The definition of new construction used in the compilation of this data includes new buildings and structures, additions, alterations, major replacements, mechanical and electrical installations, site preparation, and installation of some types of equipment. Not included in the definition of new construction are maintenance and repairs to existing structures, cost and installation of most types of production machinery, and land acquisition.

Variables included in the computation of the value of construction put in place are the cost of materials, cost of labor and equipment, contractor's profit, cost of engineering and architectural work, overhead costs, and interest and taxes paid during construction.

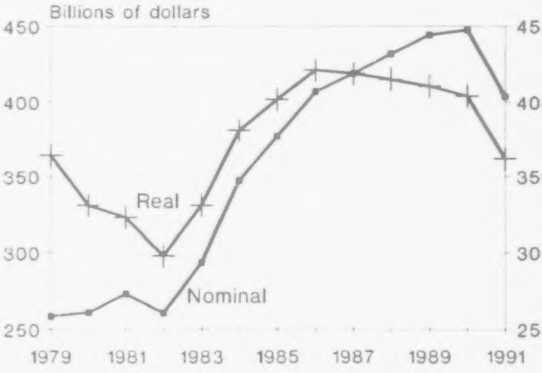
While the value of improvements and additions to residential units are included in the **Total** figure presented on page 8, it is excluded from the two residential series shown on that page so that they represent construction on new housing units only.

Inflation Adjustment

The data presented on pages 8 and 9 has been adjusted for inflation. The levels are reported in terms of *1987 Dollars*, reflecting what the value of the construction would have been if prices prevalent in 1987 were in effect.

Total Construction

As Measured in Nominal and 1987 Dollars



Source: Bureau of the Census

The price adjustment provides a measure of actual, or real, economic activity. For example, if the total amount spent on housing construction in a year increases 5% from the preceding year but cost of resources used to construct these homes has increased 10%, then the actual level of economic activity has really dropped. The conclusion about the health of the construction sector may change significantly after price effects are omitted.

The importance of removing the distortion of changing prices can be seen on the chart shown on the previous page. From 1979-82, the total amount spent on construction, or the nominal value, was rising. After rising prices are factored out, we see that the price-adusted, or real, volume was falling sharply. In another case, the nominal value of construction was rising during the 1986-90 period, but the real measure shows how activity was slowly eroding. The two lines cross in 1987 since that is the base year for the inflation adjustment.

Methodology

The data for single-family structures is computed using housing starts data multiplied by an average constant cost figure and adjusted to eliminate non-construction costs. These total costs were then divided over the course of a year using fixed patterns of monthly construction progress. The fixed patterns of monthly construction progress is a table of estimates used to approximate the percentage of the project which will be completed in each month of a twelve month construction period. These percentages are then multiplied by total construction costs to determine the value of construction put in place for a given month.

For multifamily homes, the value of construction put in place is computed using cost reports collected in a survey conducted by the U.S. Department of Commerce of 2100 hundred projects in progress. Costs from this data sample were then weighted and the weights were used to derive a value for total construction put in place.

Data for the industrial and office sectors is also computed using information from a survey of a sample number of projects in progress. The responses from 5,800 projects were weighted and used in tandem with information provided by an independent research firm to determine the value of construction put in place for these sectors.

The public construction table and chart contain the value of construction put in place data for all projects financed by federal, state, or local governments. Federal project data was collected by the Census Bureau from each federal agency involved in construction activities, while state and local data was derived using a survey of about 5,800 projects.

All the data included in the tables and charts has been seasonally adjusted to help reveal underlying trends and business cycles.

Source: Bureau of the Census, Publication C30-9105: Value of Construction Put in Place, May 1991, pages 53-68.

Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis

Jason B. Guesman
Research Assistant
Forecasting & Policy Analysis

U.S. Economic Outlook: September 1991

	91.1	91.2	91.3	91.4	92.1	92.2	92.3	92.4	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-2.8	-0.1	2.9	2.3	2.9	2.7	3.1	2.2	2.5	1.0	-0.3	2.5	2.5
Industrial Production	-9.6	2.2	6.1	4.1	3.9	4.7	5.9	4.6	2.6	1.0	-1.8	4.5	4.6
Civilian Employment	-2.4	0.3	-0.1	1.2	1.4	1.5	1.6	1.3	2.0	0.5	-0.8	1.1	1.3
GNP Inflation Index	5.2	4.2	3.3	3.2	3.3	2.6	2.6	2.6	4.1	4.1	4.0	3.1	2.8
Consumer Prices	3.5	2.1	3.1	3.4	3.4	3.2	3.4	3.5	4.8	5.4	4.3	3.3	3.4
Value of the U.S. Dollar	8.0	45.9	4.7	-0.5	-1.8	-1.3	-1.1	-0.9	6.2	-9.6	2.6	1.9	0.3
Percent													
Mfg. Capacity Utilization	78.0	77.8	78.4	79.0	79.5	80.2	81.1	81.8	84.0	82.3	78.3	80.6	83.3
Civilian Unemployment	6.5	6.8	6.8	6.7	6.7	6.6	6.5	6.4	5.3	5.5	6.7	6.6	6.3
Percent of GNP													
Federal Tax Receipts	20.4	20.3	20.2	20.3	20.5	20.5	20.5	20.5	20.2	20.3	20.3	20.5	20.5
Federal Expenditures	22.7	23.6	23.6	24.2	24.4	24.3	24.1	23.9	22.8	23.3	23.5	24.2	23.7
Federal Budget Deficit	-2.3	-3.3	-3.4	-3.9	-3.9	-3.8	-3.6	-3.4	-2.6	-3.0	-3.2	-3.7	-3.1
Interest Rates, Percent													
Federal Funds Rate	6.4	5.9	5.6	5.5	5.7	5.8	5.8	5.8	9.2	8.1	5.9	5.8	5.8
3-Month T-Bill Rate	6.0	5.6	5.4	5.3	5.3	5.2	5.2	5.1	8.1	7.5	5.6	5.2	5.1
Prime Rate	9.2	8.7	8.4	8.2	8.2	8.4	8.3	8.3	10.9	10.0	8.6	8.3	8.2
Discount Rate	6.2	5.7	5.4	5.1	5.1	5.1	5.1	5.1	6.9	7.0	5.6	5.1	5.0
Corporate AAA Bond Yield	8.9	8.9	8.7	8.5	8.4	8.3	8.2	8.0	9.3	9.3	8.8	8.2	7.6
30-Year Government Bond Yield	8.2	8.3	8.2	7.9	7.8	7.8	7.7	7.6	8.4	8.6	8.1	7.7	7.3
Mortgage Rates, Percent													
30-Year Fixed Rate	9.5	9.5	9.3	9.1	9.0	9.0	8.9	8.7	10.3	10.1	9.4	8.9	8.4
1-Year Adjustable	8.1	7.6	7.1	7.0	6.9	6.9	6.8	6.8	9.3	8.4	7.2	6.8	6.7
Home Sales & Starts													
Thousands													
Total Single-Family Sales*	3,798	4,286	4,295	4,333	4,350	4,401	4,444	4,477	4,413	4,164	4,178	4,418	4,587
Existing Single-Family Sales	3,093	3,480	3,423	3,459	3,484	3,515	3,529	3,558	3,440	3,296	3,364	3,522	3,621
New Single-Family Sales	464	506	487	511	519	534	551	564	650	534	492	542	593
Housing Starts	915	997	1,072	1,079	1,073	1,102	1,156	1,179	1,376	1,193	1,016	1,128	1,279
Single-Family Units	726	831	899	901	893	914	943	948	1,003	895	839	924	997
Multi-Family Units	189	166	173	178	180	189	213	232	373	298	177	203	282
2-4 Family Units	31	31	32	32	31	32	35	37	55	38	31	33	41
5+ Family Units	158	135	141	146	149	157	178	195	318	260	145	170	241
Mobile Homes Shipped	161	174	206	223	228	234	240	239	199	188	191	235	239
Percent change -- Year Ago													
Total Single-Family Sales	-15.2	1.3	4.1	11.7	14.6	2.7	3.5	3.3	-4.4	-5.9	-0.0	5.8	3.8
Existing Single-Family Sales	-10.2	3.5	3.8	11.0	12.6	1.0	3.1	2.9	-3.6	-4.7	2.1	4.7	2.8
New Single-Family Sales	-22.3	-6.2	-6.9	8.8	11.9	5.4	13.1	10.3	-3.3	-18.5	-7.8	10.1	9.4
Housing Starts	-36.1	-17.2	-5.2	3.6	17.2	10.5	7.8	9.3	-7.5	-13.3	-14.8	11.0	13.4
Single-Family Units	-31.8	-7.2	5.0	14.6	23.0	9.9	4.9	5.1	-7.3	-10.8	-6.2	10.1	7.8
Multi-Family Units	-48.7	-46.1	-37.0	-30.5	-4.9	13.6	23.0	30.2	-8.0	-20.1	-40.7	15.1	38.7
2-4 Family Units	-27.1	-27.7	-1.3	2.0	-0.8	0.8	9.6	15.5	-5.8	-32.1	-16.1	6.3	22.0
5+ Family Units	-51.5	-49.1	-41.7	-34.9	-5.7	16.5	26.0	33.3	-8.3	-18.0	-44.3	17.0	42.0
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	95.9	101.1	102.7	103.0	103.6	104.5	105.4	106.2	93.1	95.5	100.7	104.9	109.5
New Home Prices	120.2	120.0	120.7	123.2	125.4	126.3	128.3	129.5	120.0	122.9	121.1	127.4	132.9
Percent Change - Year Ago													
Existing Home Prices	0.5	4.7	6.3	11.7	8.0	3.3	2.6	3.1	4.4	2.6	5.8	4.2	4.4
New Home Prices	-2.9	-5.2	3.5	1.0	4.3	5.2	6.2	5.1	5.9	2.4	-1.0	5.2	4.3

Quarterly figures are seasonally adjusted annual rates.

* Total single-family sales equals single-family resales plus 97% of single-family housing starts.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of the current condition of the U.S. economy, easy-to-read forecasts for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets.

If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

Editorial questions can be directed to Robert Barr at (202) 383-7525.

REALTOR®

EQUAL HOUSING
OPPORTUNITY

A7000-1

Real Estate
OUTLOOK

October 1991

With oil prices back to pre-crisis levels, sharply lower interest rates, and economic growth returning in the third quarter, the fourth quarter was supposed to see even stronger growth. But virtually all of the anecdotal evidence and a growing amount of the statistical evidence suggests a recovery that's still seriously limping. According to the NAR forecast, lower interest rates, the restocking of inventories and the improving inflation picture will allow the recovery to revive early next year after a stagnant fourth quarter. *Page 2*

Housing starts edged up another 0.6% in August to 1.065 million units. When compared with the average 4% monthly gains recorded since April of this year, August's performance appears lackluster. However, the stellar performance in the spring reflects the release of the pent-up demand resulting from the Persian Gulf War. Now that this has dissipated, recovery is expected to be gradual. *Page 4*

The rate of exising home sales deteriorated for the second consecutive month in August. After a 5-month rally, which resulted in an overall gain of 23.8%, the resale rate contracted 7.5% in July and another 2.1% in August. The resale rate currently stands at 3.25 million, which is 4.7% below the rate recorded one year ago. *Page 6*

Also In This Issue:

Accent-u-ate the Positive, E-lim-i-nate the Negative — *Economic Commentary by John A. Tuccillo* — *Page 1*

Outlook for the Economy & Real Estate — *Robert D. Barr, Kimberly A. Martin & Jason B. Guesman* — *Pages 2-9*

Commercial Real Estate Outlook — *Ruth Sergenian* — *Pages 10-1*

NATIONAL ASSOCIATION OF REALTORS®
REALTOR® *The Voice for Real Estate* ™

Forecasting & Policy Analysis Division
NATIONAL ASSOCIATION OF REALTORS®
777 14th Street, NW Washington, D.C. 20005

Copyright 1991
NATIONAL ASSOCIATION OF REALTORS®

Accent-u-ate the Positive, E-lim-i-nate the Negative

by John A. Tuccillo
Chief Economist and Senior Vice President
Real Estate Finance

Ben and Jerry's produces an ice cream flavor called (pun intended) Cherry Garcia. They promote it with a '60s style tie-dyed T-shirt bearing the legend, "What a long weird dip it's been." Without explaining this to non-Deadhead readers, let's adopt it to characterize the current recovery/recession (you make the call!).

We are experiencing an unusual sequence of economic events. By growth standards, this has been a mild recession. But in the process, the economy lost many jobs. The strength of the export sector through the recession has been insufficient to offset the shrinkage in financial services and the stagnation in high tech industries.

Moreover, we are cursed by the composition effect, because job growth has occurred in the Midwest and Pacific Northwest, while the economy lost jobs on both coasts. So, most *places* are experiencing recovery, but -- because those places are relatively unpopulated -- most *people* are not. The people who feel good in Oregon don't outweigh those who are feeling bad in Massachusetts.

Even now, we still see layoffs exceeding 2,000 per day, and the total for the year to date has exceeded all of 1990. The legacy is a limping recovery that few believe in. Consumption--some two-thirds of total economic activity--has been hamstrung by doubts that things are getting better. In a sense, consumers want to find out how the record will end before they'll get up to dance.

Housing is the same. Mortgage rates have fallen to levels unseen in fourteen years; the likelihood of further Fed easing suggests that they will decline even more. Yet, home sales seem immune from lower rates. In fact, there is a dichotomy in the market. First-time buyers -- those at the margin of homeownership -- have been highly responsive to the fall in rates and, in virtually all markets, business is brisk in the lower price ranges.

Trade-up buyers are less responsive to rates and much more sensitive to confidence factors. They see the ambiguities of the economy and are reluctant to take the risks of a larger mortgage debt on a more expensive house. That reluctance translates into a weaker market in the upper price ranges, and the total home sales number looks weak.

As mortgage rates continue to fall, more buyers will be drawn into the market. But this will be a marginal improvement; recovery of home sales will require strong job growth and a return of consumer confidence.

Consumer confidence is the key. We thought the recovery had arrived in February, when the end of the Gulf War raised spirits and opened wallets. Now it seems that it was all a mirage, a burst of pride and adrenaline that had little staying power. First consumer spending and later housing fell back into that twilight zone that is neither recession nor recovery.

The Administration and the Congress chose to ride that false wave of optimism, adopting a cheerleading posture that urged consumers to (in the words of the song) *"put me on the highway, and show me a sign and take it to the limit one more time"* -- i.e., recreate the spending orgy of the Eighties. This would take the place of any real and creative solution to the recession.

Unfortunately, it's not that simple. Public relations sloganeering could not hide the installment bills that arrived every month, or disguise the unemployment numbers. The American people have translated these facts into a deep pessimism about the future, made all the more painful by the high hopes of last February. Astonishingly, the result has been the first time in memory that the *public* was more pessimistic than the *economists.*

Jobs are also a problem, not only in numbers but in types. This was a "white collar" recession in that the jobs we lost were largely managerial and located in big cities. To a great extent, this explains why the recession was felt more deeply in housing and in the Northeast. Even as the economy comes back, there is little assurance that the jobs we gain will go to the same faces in the same places.

This recession has occurred amidst a changed structure of economic activity. Globalization and technological change will drive the economy of the Nineties; the recession of 1981-82 forced businesses to become leaner in the management of their resources; evolution in the financial sector has decimated the corps of middle managers; and an information based society puts a high premium on knowledge skills.

All this suggests a reshuffling of economic activity toward smaller enterprises serving a global market and located in second tier cities. These are the sectors that will ultimately produce recovery. But where does this leave economic policy? Creating the best environment for these changes involves a focus on investment incentives, education and capital renewal. In short, the signposts point to a "back to basics" economic policy.

In the short term, the economy will recover. The more relevant question, however, is: recover to what? Real growth in the Nineties requires a commitment to savings and investment on a national level. The military standdown facing us ought to provide some seed money. Ultimately, though, recovery will entail revitalization.

This month, the President attended the Country Music Association awards ceremonies. He heard there one of the best policy prescriptions any economist could offer him in the words of a song by Ricky Van Shelton:

Keep your hands on the wheel,
Believe in the things that are real.
Take your time, and keep it between the lines.

Outlook for the Economy

From the outset of the year, the fourth quarter of 1991 was expected to be everything the first quarter wasn't. At the beginning of the year, the economy was coping with a recession, a 60% runup in oil prices, and the uncertainty facing a nation on the brink of war. Now, with oil prices back to pre-crisis levels, victories recorded in both the Persian Gulf and Cold Wars, sharply lower interest rates, and a quarter of healthy economic growth under our belts, the fourth quarter is supposed to be another quarter of robust growth.

But virtually all of the anecdotal evidence and a growing amount of the statistical evidence suggests a recovery that's still seriously limping. What happened? After all, by late spring, the war was over, our oil supplies secure, and interest rates were falling. After months of pessimism and pent-up demand, the consumer was loaded for bear. The housing markets rebounded, and consumer spending rose. The recovery, while modest, seemed certain. Now it appears the consumers were, in fact, barely loaded -- income growth did not keep pace with spending, debt remained high, and the saving rate fell. All of this caught up with the consumer, and now it's the recovery that appears shot.

According to the NAR forecast, lower interest rates, the restocking of inventories and the improving inflation picture will allow the recovery to remain intact, although the fourth quarter's projected 1.3% rate of expansion will feel like the continuation of the recession to many regions and industries. The rate of growth is expected to double to 2.6% in 1992's first quarter and then reach 3.6% the following quarter. In all, the economy is expected to record a 0.5% contraction in 1991 and a 2.5% expansion in 1992.

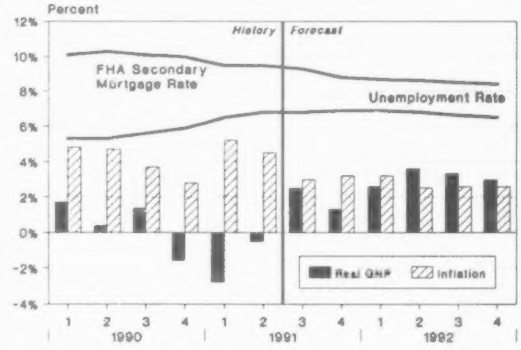
Second Quarter Momentum Spills Over

Third-quarter figures will look healthy when the initial estimates are released at the end of October. Largely reflecting the momentum the economy had at mid-year, they will not show how the economy has faltered in the past ten weeks or so. August's decline in consumer expenditures is only one sign of the slowing recovery. Also during August, for example, existing home sales slid for the second consecutive month, auto sales fell, and industrial production lowered its rate of increase. Also down, for the third consecutive month, was consumers' confidence about the health of the economy.

Consumption growth picked up in June and July but slipped in August (see chart). For the third quarter, a 3.3% annual growth rate is expected, pacing GNP to a 2.5% gain for the quarter. But just as momentum was building up in the early part of the summer, it began dropping off in late summer. While the fourth quarter is expected to see growth -- instead of a dip back into recession -- the economy's increase is expected to be just half of the previous quarter's gain.

Worsening job prospects and slow income growth have dampened consumer enthusiasm. The consumer has also been squeezed by a rising tax burden. Taxes collected from households rose at a 6.7% average annual rate since the end of 1988; personal income, the underlying source of these revenues, grew at only a 5.5% rate. The budget shortfalls that shuttered some state governments earlier

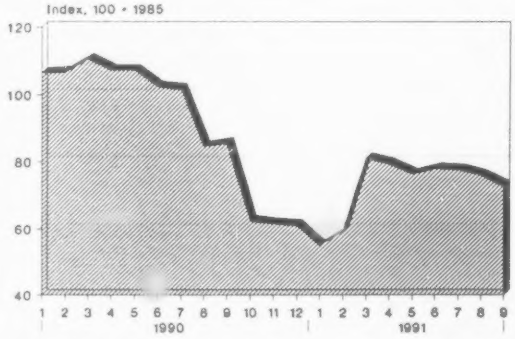
The Economic Outlook



Sources: BEA, BLS, FHLMC, NAR forecast

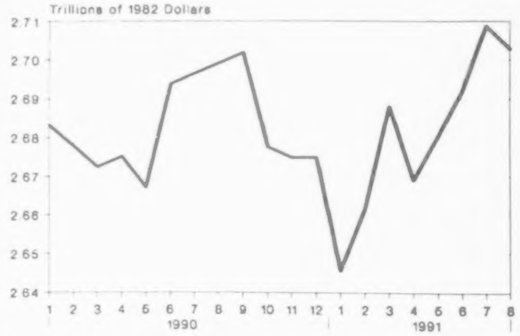
Consumer Confidence On the Wane

Continues Trend Seen Since Before Gulf Crisis



Source: Conference Board

Consumer Expenditure Gains Fuel Third Quarter Growth



Source: Bureau of Economic Analysis

this year came in the face of a 7.2% rate of increase in state and local personal tax receipts.

Employment Growth Returns

After two quarters of decline, nonfarm employment showed modest growth in the third quarter (see chart). Manufacturing employment, which had been particularly hard-hit in the year's first half, squeaked out a 0.3% gain. In September, the unemployment rate fell to 6.7% from the 6.8% rate recorded in the two previous months. The rate is expected to reverse course in coming months, returning to 6.8% due to the fourth quarter's slow growth. By mid-1992, the unemployment rate is expected to resume its descent, reaching 5.9% by the end of 1993. The numerous layoffs and corporate restructurings that have been announced recently will be countered somewhat by less heralded expansions in other sectors of the economy.

Fed Shows Patience

As usual, the Federal Reserve is caught in a tight spot where patience, rather than action, may turn out to be a virtue. The Fed lowered its target on the bellwether federal funds rate in August and again in September, and now it appears to be standing pat, waiting to see if these moves will be enough to revive the recovery. Overstimulating the economy by making further cuts at this point in the recovery is a trap that's caught the Fed before. The result is more inflation -- and higher long-term interest rates -- down the road. Of course, it's unclear that another interest rate cut would in fact overstimulate the economy. Given the weakness of the recovery, another rate cut or two may mean the difference between weak growth and suffering another quarter or two of contraction.

The Fed is also getting some help from long-term rates, which began falling in late July after remaining steady throughout most of the year (see chart). Yields on 30-year fixed mortgages, for example, have slipped by over a half-point since early August, and now stand close to 8.9%. Consequently, the Fed is waiting to see what effect these lower rates will have on the economy.

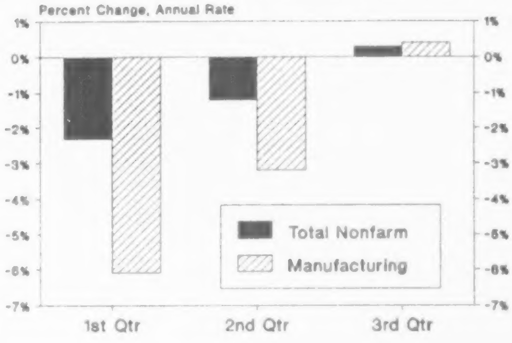
Inflation Remains A Bright Spot

The economy is expected to receive a lift from the continuing moderation of inflation, as shown in the chart. While reflecting the general weakness in the economy, lower inflation enhances consumer purchasing power and allows interest rates to fall further. In the past six months, consumer prices rose at a 2.2% annual rate, while the core index, which excludes food and energy prices, rose 3.3%. This compares with 1990's increases of 6.1% and 5.2%, respectively. Inflation at the producer level has actually disappeared in the past six months, as the Producer Price Index posted a 0.2% annual rate of decline. According to the forecast, inflation as measured by the Consumer Price Index is projected to rise only 4.2% in 1991 and 3.2% in 1992.

Robert D. Barr
Director of Forecasting
Forecasting & Policy Analysis

Employment On The Mend

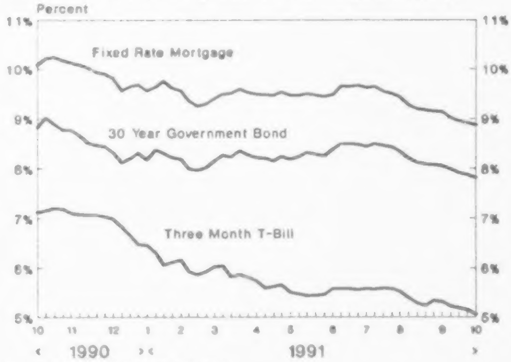
Steep Declines Over, But Recent Gains Weak



Source: Bureau of Labor Statistics

Interest Rates Slide

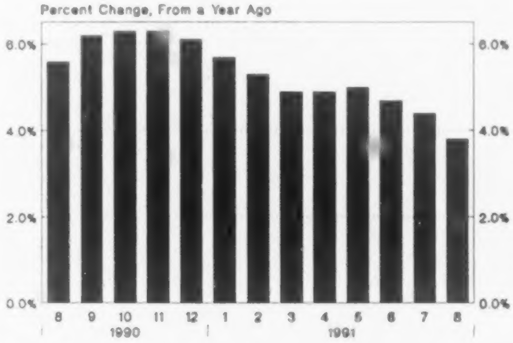
Fall for Long-Term Rates Began in July



Source: Federal Reserve Board

Inflation Moderates

Consumer Price Index



Source: Bureau of Labor Statistics

Housing Starts

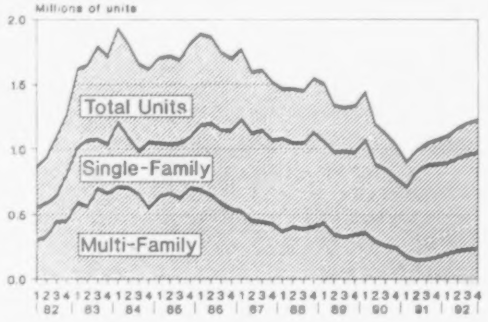
National Data

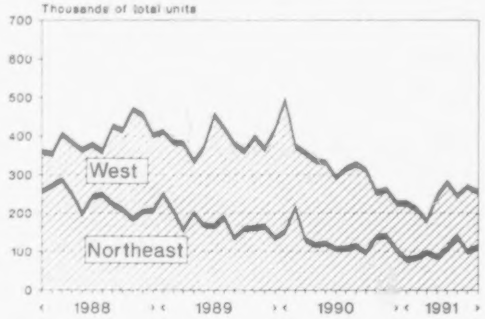
	Total	SF	MF:2-4	MF:5+
Aug 1990	1,131	835	30	266
Mar 1991	907	742	28	137
Apr 1991	977	801	32	144
May 1991	983	831	36	116
Jun 1991	1,034	869	24	141
Jul 1991	1,059	887	44	128
Aug 1991	***1,065***	***892***	***47***	***126***
Annual Averages:				
1989	1,376	1,003	55	318
1990	1,193	895	38	260
Percent Changes in August 1991 since:				
Aug 1990	-5.8	6.8	56.7	-52.6
Jul 1991	0.6	0.6	6.8	-1.6

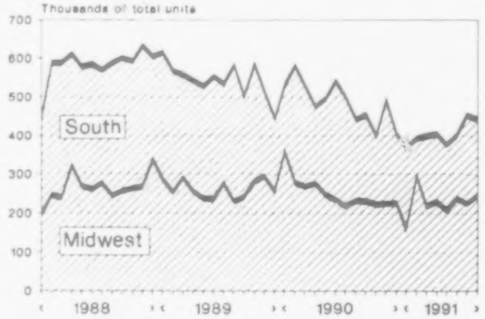
Regional Data

	Northeast	Midwest	South	West
Aug 1990	122	240	434	335
Mar 1991	104	226	390	187
Apr 1991	93	236	395	253
May 1991	114	216	367	286
Jun 1991	145	244	393	252
Jul 1991	107	232	444	276
Aug 1991	***119***	***251***	***433***	***262***
Annual Averages:				
1989	179	266	536	396
1990	131	253	479	329
Percent Changes in August 1991 since:				
Aug 1990	-2.5	4.6	-0.2	-21.8
Jul 1991	11.2	8.2	-2.5	-5.1

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







Housing starts edged up another 0.6% in August to 1.065 million units. When compared with the average 4% monthly gains recorded since April of this year, August's performance appears lackluster. However, the stellar performance in the spring reflects the release of the pent-up demand resulting from the Persian Gulf War. Now that this has dissipated, recovery is expected to be gradual.

The construction of single-family homes was listless in August, with starts increasing an anemic 0.6% to 892,000 units. In the multifamily market, performance was mixed. The construction of homes with 2 to 4 units increased a robust 6.8% to 47,000 units, while the construction of homes with 5 or more units declined 1.6% to 126,000 units.

Of the four Census reporting regions, the Northeast recorded the largest increase in August. After a disappointing 26.2% decline in July, starts rebounded 11.2% to 119,000 units. Building activity was also strong in the Midwest, where starts advanced 8.2% to 251,000 units. In the West, starts dropped 5.1% to 262,000 units, while the South saw a more modest decline of 2.5% to 433,000 units.

According to the NAR forecast, housing starts are expected to average 1.075 million units during the second half of this year, which translates into a 12.3% gain over the first half of 1991. Falling mortgage rates will continue to fuel housing construction into 1992. Starts of multifamily homes will account for much of the gain in 1992, advancing 32.8% to 236,000 units, while single-family starts will post a healthy 13.5% increase to 951,000 units.

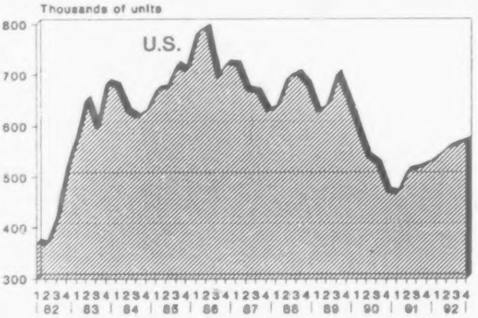
National Data

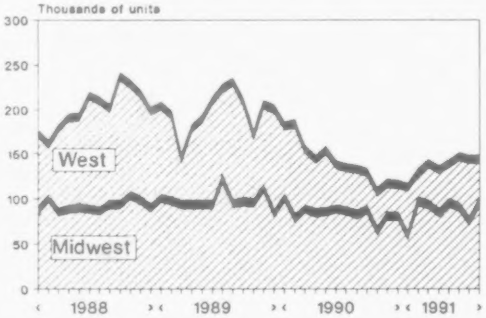
		Mo. Ago % Chg.	Yr. Ago % Chg.
Aug 1990	525	-3.0	-27.0
Sep 1990	504	-4.0	-21.0
Oct 1990	465	-7.7	-26.9
Nov 1990	480	3.2	-30.1
Dec 1990	464	-3.3	-26.7
Jan 1991	414	-10.8	-34.0
Feb 1991	488	17.9	-19.5
Mar 1991	495	1.4	-11.4
Apr 1991	506	2.2	-5.2
May 1991	507	0.2	-5.1
Jun 1991	520	2.6	-5.3
Jul 1991	506	-2.7	-6.5
Aug 1991	*540*	*6.7*	*2.9*
Annual Averages:			
1989	650		-3.3
1990	534		-17.8

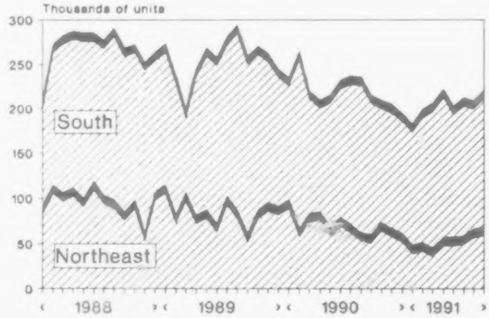
Regional Data

	Northeast	Midwest	South	West
Aug 1990	63	88	236	138
Mar 1991	46	99	206	144
Apr 1991	58	90	222	137
May 1991	58	101	203	144
Jun 1991	59	96	212	152
Jul 1991	67	81	209	149
Aug 1991	*69*	*101*	*221*	*149*
Annual Averages:				
1989	86	102	260	202
1990	71	89	225	149
Percent Changes in August 1991 since:				
Aug 1990	9.5	14.8	-6.4	8.0
Jul 1991	3.0	24.7	5.7	0.0

Levels are seasonally adjusted annual rates, in thousands.
Source: Bureau of the Census, Construction Reports, Series C25







After dipping in July, new home sales rebounded 6.7% in August. The continued decline in mortgage rates, which have fallen nearly one percentage point since August of 1990, brought a stream of home buyers into the market. August's rate of 540,000 units is the highest figure recorded in one year.

Three of the four Census reporting regions recorded increases in August, but most of the gain was concentrated in the Midwest. An increase of 24.7% puts August's rate of 101,000 units 14.8% above the rate recorded in August of 1990. In the South, the sales pace also gathered momentum, increasing 5.7% to 221,000 units.

After advancing an impressive 13.6% in July, sales increased another 3.0% in the Northeast in August. These latest gains provide further evidence that the market has finally bottomed out in the Northeast. In the West, the sales pace held steady at July's rate of 149,000 units, which is 8.0% above the figure recorded one year ago.

According to the NAR forecast, the sales rate will average 520,000 units during the latter half of 1991. As a more sustainable recovery takes hold, the sales pace is expected to accelerate. In the first half of 1992, the sales rate is forecast to average 547,000 units. Additional gains are projected for the remainder of 1992, and for the entire year sales are expected to post a 10.4% gain over 1991.

Low mortgage rates will continue to fuel the demand for new homes in 1993. Overall, the sales rate is projected to increase a healthy 5.3% to 586,000 units in 1993.

Existing Home Sales

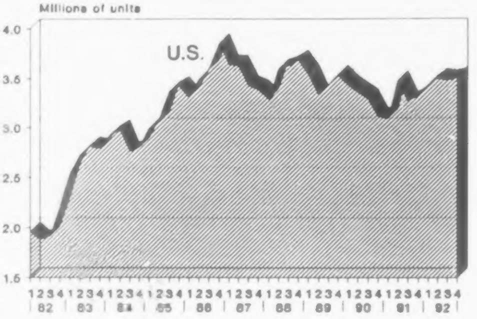
National Data

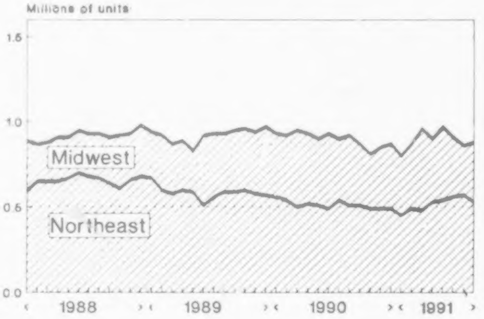
		Mo. Ago % Chg.	Yr. Ago % Chg.
Aug 1990	3,410	2.7	-0.9
Sep 1990	3,160	-7.3	-10.0
Oct 1990	3,070	-2.8	12.0
Nov 1990	3,150	2.6	-11.5
Dec 1990	3,130	-0.6	-12.1
Jan 1991	2,900	-7.3	-16.4
Feb 1991	3,160	9.0	-7.6
Mar 1991	3,220	1.9	-6.4
Apr 1991	3,310	2.8	-1.8
May 1991	3,540	6.9	5.7
Jun 1991	3,590	1.4	6.5
Jul 1991	3,320	-7.5	0.0
Aug 1991	*3,250*	*-2.1*	*-4.7*
Annual Averages:			
1989	3,440		-4.3
1990	3,296		-4.2

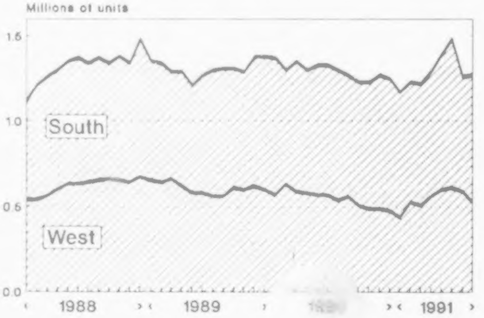
Regional Data

	Northeast	Midwest	South	West
Aug 1990	520	930	1,380	570
Mar 1991	490	970	1,230	520
Apr 1991	540	910	1,300	570
May 1991	550	980	1,400	610
Jun 1991	570	920	1,490	620
Jul 1991	580	870	1,270	600
Aug 1991	*540*	*890*	*1,280*	*540*
Annual Averages:				
1989	589	919	1,307	610
1990	522	892	1,325	557
Percent changes in August 1991 since:				
Aug 1990	3.8	-4.3	-7.2	-5.3
Jul 1991	-6.9	2.3	0.8	-10.0

Levels are seasonally adjusted annual rates, in thousands.
Source: National Association of Realtors, 'Home Sales'







The rate of existing home sales deteriorated for the second consecutive month in August. After a 5-month rally which resulted in an overall gain of 23.8%, the resale rate contracted 7.5% in July and another 2.1% in August. The resale rate currently stands at 3.25 million units, which is 4.7% below the rate recorded one year ago.

The surge of activity that began in February reflected renewed consumer optimism at the close of the Gulf War and a desire to take advantage of low mortgage rates. Now that the pent-up demand has been spent, the market is returning to a more sustainable course of growth.

By region, the Midwest recorded the largest gain in August, with sales increasing 2.3% to 890,000 units. The South also posted an increase in August, with sales edging up 0.8% to 1.28 million units. Both the West and the Northeast suffered losses in August, with the West taking the hardest hit. Sales dropped 10.0% to 540,000 units in the West, and 6.9% to 540,000 units in the Northeast.

After a weak third quarter, the sales pace is expected to pick up during the fourth quarter of 1991. By year end, the resale rate should stand at 3.33 million units, which translates into a 1.7% gain over the third quarter's figure of 3.27 million units.

These gains, combined with lower mortgage rates, will position the resale market for stable growth in 1992, when sales are projected to increase 5.8% to 3.48 million units. In 1993, the rate of existing home sales will continue to increase, but at the slower pace of 2.3% to 3.56 million units.

Prices of New & Existing Homes

National Data

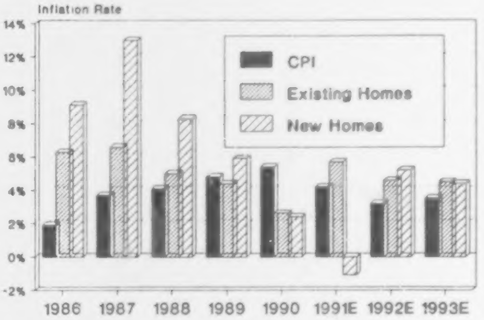
	Median		Average	
	Existing	New	Existing	New
Aug 1990	97,200	118,400	120,700	144,700
Mar 1991	98,200	122,500	125,200	156,400
Apr 1991	100,300	121,000	128,900	150,800
May 1991	101,100	116,000	130,600	145,400
Jun 1991	102,000	119,500	130,500	145,800
Jul 1991	103,600	119,900	132,200	148,400
Aug 1991	***101,800***	***122,000***	***130,500***	***141,800***
Annual Averages:				
1989	93,100	120,000	118,100	148,800
1990	95,500	122,900	118,600	149,800
Percent changes in August 1991 since:				
Aug 1990	4.7	3.0	8.1	-2.0
Jul 1991	-1.7	1.8	-1.3	-4.4

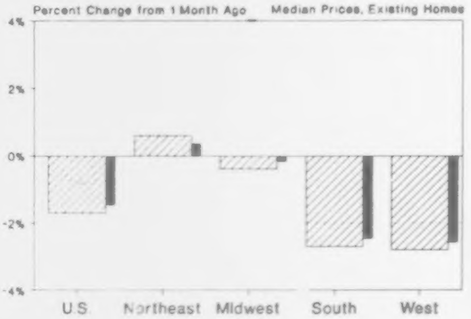
Regional Data

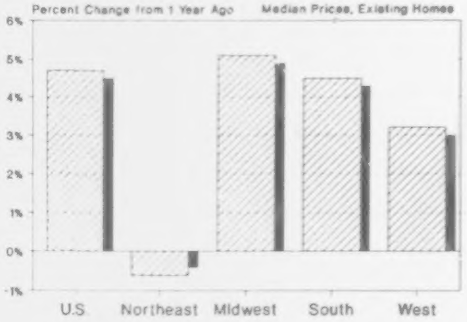
Median Prices for Existing Single-Family Homes

	Northeast	Midwest	South	West
Aug 1990	145,300	75,100	87,200	140,200
Mar 1991	142,700	78,200	87,300	147,300
Apr 1991	144,800	77,900	88,000	151,000
May 1991	144,900	77,500	88,900	152,100
Jun 1991	141,800	78,300	90,700	148,600
Jul 1991	143,500	79,200	93,600	148,800
Aug 1991	***144,400***	***78,900***	***91,100***	***144,700***
Annual Averages:				
1989	145,200	71,300	84,500	139,900
1990	141,200	74,000	85,900	139,600
Percent changes in August 1991 since:				
Aug 1990	-0.6	5.1	4.5	3.2
Jul 1991	0.6	-0.4	-2.7	-2.8

Levels are shown in dollars.
Source: National Association of Realtors, 'Home Sales'







After increasing 5.5% since March of 1991, the median price of existing single-family homes softened in August, dropping 1.7% to $101,800. Despite this decline, the median price remains 4.7% above the figure recorded one year ago.

Meanwhile, in the market for new homes, a recent decline in the number of units available for sale is expected to moderate any decline in price. August's figure, which increased 1.8% from July, reflects this tighter inventory.

On a regional basis, the Northeast was the only region to record an increase in the median price of existing homes in August. The median price edged up 0.6% from July's figure of $143,500. Each of the remaining regions experienced price declines in August. In the West, the median price decreased 2.8% to $144,700. The South experienced a comparable decline of 2.7% to $91,100, while the price in the Midwest fell 0.4% to $78,900.

Prices for both existing and new homes are expected to appreciate modestly over the forecast interval. During the latter half of 1991, median prices of existing single-family homes are expected to average $102,700. This represents a 4.3% increase over the first half of 1991. In 1992, the median price will continue to firm, increasing 4.6% to $105,300.

During the second half of 1991, the median price of new single-family homes should stand 2% above the figure for the first half of 1991. Building on this momentum, prices will continue to appreciate in 1992, increasing 5.2% to $127,300. In 1993, prices are projected to increase 4.4% to $132,800.

Construction

Value of Construction Put in Place

Total

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Aug 1990	403.0	-1.0	-1.5
Sep 1990	393.3	-2.4	-4.4
Oct 1990	391.2	-0.5	-3.8
Nov 1990	388.8	-0.6	-5.6
Dec 1990	380.6	-2.1	-6.4
Jan 1991	366.5	-3.7	-11.8
Feb 1991	369.3	0.8	-12.6
Mar 1991	362.0	-2.0	-13.9
Apr 1991	366.8	1.3	-10.9
May 1991	359.3	-2.0	-11.9
Jun 1991	357.3	-0.6	-12.1
Jul 1991	361.4	1.1	-11.2
Aug 1991	***361.6***	***0.1***	***-10.3***

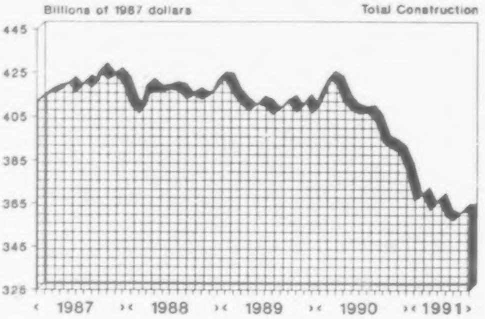
Single-Family Housing

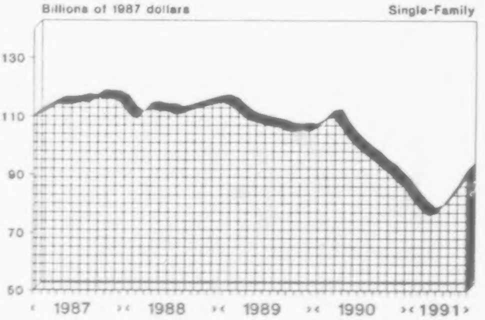
	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Aug 1990	95.3	-2.1	-10.4
Sep 1990	92.8	-2.6	-11.9
Oct 1990	90.9	-2.0	-13.4
Nov 1990	88.0	-3.2	-16.4
Dec 1990	85.7	-2.6	-18.5
Jan 1991	81.8	-4.6	-23.2
Feb 1991	78.6	-3.9	-28.2
Mar 1991	76.3	-2.9	-30.6
Apr 1991	77.0	0.9	-27.3
May 1991	79.7	3.5	-22.1
Jun 1991	83.2	4.4	-16.3
Jul 1991	87.1	4.7	-10.5
Aug 1991	***91.7***	***5.3***	***-3.8***

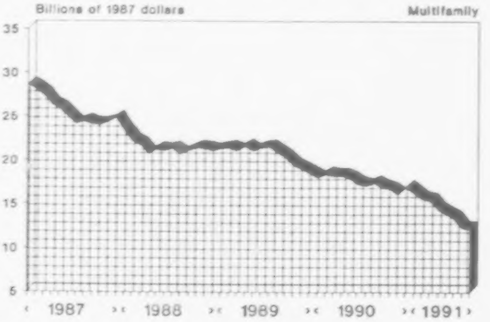
Multifamily Housing

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Aug 1990	17.4	1.8	-16.7
Sep 1990	16.9	-2.9	-16.7
Oct 1990	16.7	-1.2	-13.9
Nov 1990	16.1	-3.6	-15.3
Dec 1990	16.9	5.0	-8.6
Jan 1991	16.3	-3.6	-9.4
Feb 1991	15.6	-4.3	-15.2
Mar 1991	15.4	-1.3	-15.4
Apr 1991	14.4	-6.5	-20.9
May 1991	13.9	-3.5	-22.3
Jun 1991	13.4	-3.6	-22.5
Jul 1991	12.3	-8.2	-28.1
Aug 1991	***12.2***	***-0.8***	***-29.9***

Levels are seasonally adjusted billions of 1987 dollars
Source: Bureau of the Census







The total value of construction put in place inched up 0.1% in August to $361.6 billion after posting a gain of 1.1% in July. This is the first increase in consecutive months since February 1990, when the current slide in construction began.

In the residential sector, single-family housing construction continued its strong recovery, while the value of multifamily construction remained in the doldrums of a saturated market. After a year of continuous decline, single-family construction has rebounded with gains in the last five months. August's gain of 5.3% to $91.7 billion is the largest in this string of increases. Multifamily construction fell for the eighth consecutive month. August's 0.8% decline, which is the smallest drop in the current streak, left expenditures 29.9% below the level of a year ago.

Value of Construction Put in Place

*Offices**

	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Aug 1990	25.8	-2.3	-10.4
Sep 1990	25.7	-0.4	-11.1
Oct 1990	25.0	-2.7	-11.7
Nov 1990	24.2	-3.2	-14.8
Dec 1990	24.0	-0.8	-12.7
Jan 1991	23.2	-3.3	-16.2
Feb 1991	23.3	0.4	-15.3
Mar 1991	22.0	-5.6	-19.1
Apr 1991	23.7	7.7	-10.9
May 1991	20.9	-11.8	-16.7
Jun 1991	20.3	-2.9	-22.8
Jul 1991	19.7	-3.0	-25.4
Aug 1991	***18.7***	*-5.1*	*-27.5*

*Industrial**

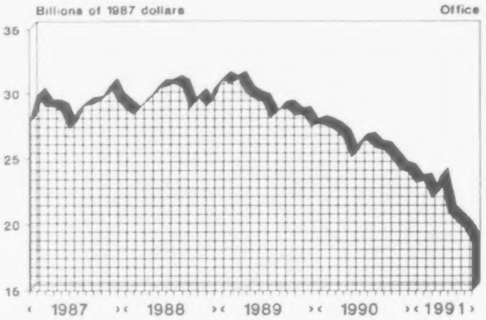
	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Aug 1990	20.5	-16.3	3.0
Sep 1990	20.3	-1.0	-1.5
Oct 1990	20.5	1.0	3.0
Nov 1990	20.2	-1.5	2.0
Dec 1990	20.7	2.5	8.9
Jan 1991	20.2	-2.4	-3.8
Feb 1991	20.9	3.5	-9.1
Mar 1991	20.7	-1.0	-7.6
Apr 1991	21.9	5.8	0.0
May 1991	18.7	-14.6	-15.0
Jun 1991	18.7	0.0	-13.8
Jul 1991	18.7	0.0	-23.7
Aug 1991	***18.2***	***-2.7***	***-11.2***

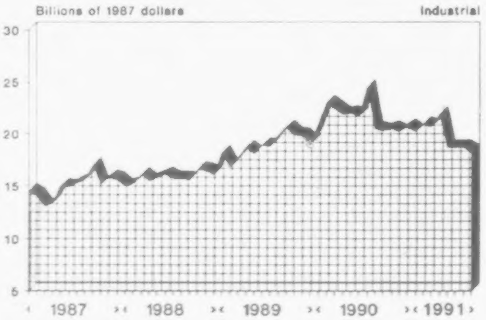
Public

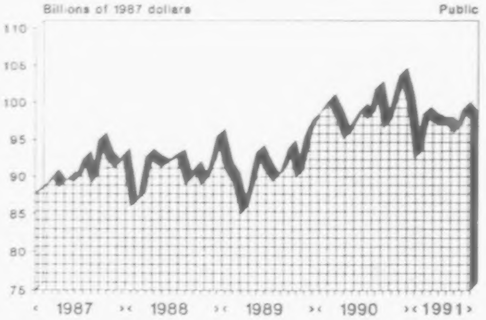
	Level	Mo. Ago % Chg.	Yr. Ago % Chg
Aug 1990	101.8	4.1	12.4
Sep 1990	96.6	-5.1	2.9
Oct 1990	99.9	3.4	11.1
Nov 1990	103.6	3.7	8.8
Dec 1990	100.0	-3.5	2.5
Jan 1991	92.5	-7.5	-6.2
Feb 1991	98.4	6.4	-1.7
Mar 1991	97.5	-0.9	-0.4
Apr 1991	97.0	-0.5	2.0
May 1991	97.0	0.0	-0.2
Jun 1991	95.9	-1.1	-2.9
Jul 1991	99.0	3.2	1.2
Aug 1991	***97.8***	***-1.2***	*-3.9*

**Note: In September's issue, figures for the office and industrial categories were switched in the tables. We regret any inconvenience this may have caused.*

Levels are seasonally adjusted billions of 1987 dollars
Source: Bureau of the Census







Office construction's downward spiral continued in August as the value put in place fell 5.1% to $18.7 billion. Tight credit conditions and record-setting office vacancy rates across the nation will postpone any recovery from the current descent, which began in early 1989.

Public construction continued to level off in August, falling 1.2% to $97.8 billion. The future is expected to hold much of the same as budget crunches on federal, state, and local levels make it unlikely that public works projects will be used to jump start the economy.

Kimberly A. Martin — *Jason B. Guesman*
Research Economist — *Research Assistant*
Forecasting & Policy Analysis

Commercial Real Estate Outlook

Commercial real estate markets across the country remained in a slump during 1990 and the first half of 1991. Many markets already saddled with an excess supply of space built during the mid- and late-1980s experienced worsening conditions during the recession as demand fell for most types of commercial/investment real estate. At the same time, stricter financial lending controls led to a "credit-crunch" whereby developers and investors were forced to compete for a greatly reduced pool of capital. On the positive side, the tight credit market resulted in a sharp drop in new commercial construction and allowed time for absorption of some excess space in overbuilt markets. Specific strengths and weaknesses have been identified in the commercial real estate markets of each region.

Northeast

The Northeast region has been hit hardest by the recession, suffering more severe job losses than the rest of the nation.

- The Northeast office market was troubled by a slowdown in office job growth and an overhang of excess space. The contraction of the finance, insurance and real estate industries resulted in a dramatic decline in office absorption. The average office vacancy rate in the Northeast increased faster than in any other region and effective rents declined. Concessions continued to climb in this tenant's market.

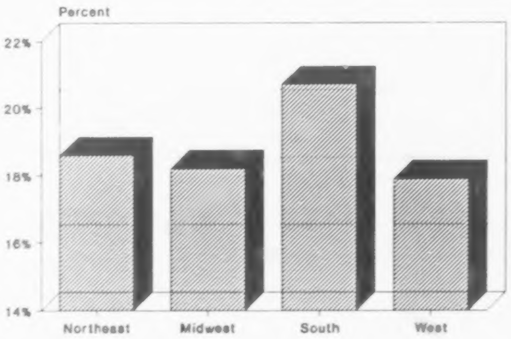
- Multifamily properties in the Northeast outperformed the other commercial property types in the region during 1990 and the first half of 1991. The region's average apartment vacancy rate remained a low 3.5 percent, considerably below vacancies in the rest of the nation.

Midwest

Real estate market conditions in the Midwest softened in the recession, yet the region's increasingly diversified economy helped temper the severity of the downturn.

Office Vacancy Rates

1991



Source: REIS Reports, Inc. 1991

- The Midwest industrial market had the lowest regional average vacancy rate in 1990 and the first half of 1991, yet the downturn in manufacturing employment resulted in a sharp drop in absorption. Vacancies inched upwards while effective rents were flat.

- The multifamily market improved modestly. Absorption of apartment units outpaced new construction, which continued to fall. Consequently, vacancies declined.

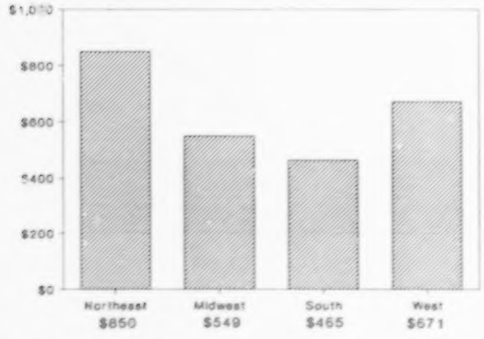
South

The economy of the diverse South region continued to outperform the nation, although growth was slower than in previous years. The recession will not be as deep and recovery should come rather quickly to some parts of the South.

- An analysis of office market statistics for the South revealed a distinct pattern in each of the subre-

Multifamily Effective Rents

1991



Source: REIS Reports, Inc. 1991

gions. In the South Atlantic, several of the strongest office markets during the late-1980s began to show signs of weakening. Meanwhile, signs of improvement were strongest in those office markets that were most heavily overbuilt in recent years in the West South Central. Finally, major markets in the East South Central subregion mirrored the general weakness of the U.S. office market, showing only faint signs of improvement.

- The retail market in the South continued to suffer from the effects of overbuilding and was burdened with the highest average retail vacancy rate in the nation. The generally weak conditions of the retail markets were exacerbated by declining consumer demand. Vacancies inched upwards as new retail centers continued to be constructed while absorption of space slowed.

West

Real estate market conditions in the West were the healthiest in the nation. The strength of the region can be attributed to its economic diversity, which shielded the West from the full effects of the recession, strong trade and investment activity with Asia and Mexico and heavy in-migration.

- The office market in the West remained the strongest in the nation. The region did not suffer from an oversupply of space to the extent seen elsewhere, and had the lowest average vacancy rate. Construction was much more in line with absorption, the average vacancy rate declined modestly and effective rents held firm.

- The West industrial market demonstrated considerable strength, largely attributable to the strong trade sector which fueled the demand for warehouse/distribution space. As new construction slowed considerably vacancy rates declined.

Conclusion

As the U.S. economy enters a subdued recovery, the demand for commercial space is not expected to regain the levels achieved in the late-1980s. Real estate firms will need to diversify beyond development into other areas such as property and asset management, and those real estate professionals that keep abreast of national trends are the ones who will continue to find the best opportunities. Identifying opportunities for commercial investment and development will require careful research as the industry becomes more competitive than ever before.

More detailed information on commercial and investment real estate market conditions, including forecasts for the remainder of 1991 and 1992, is available in the *1991 National Real Estate Review*. This annual publication is produced by the Investment Real Estate Research Department within NAR's Economics and Research Division. The report is published in four regional volumes: Northeast, Midwest, South and West. Each provides detailed analyses of economic conditions and real estate market trends during 1990 and the first half of 1991, along with an outlook for the remainder of 1991 and 1992.

Office, industrial, retail, multifamily and hotel property types are examined in depth. In addition to providing an analysis of current conditions within local markets, specific markets that are expected to improve or outperform other markets within the region during 1992 are highlighted in each volume.

The information presented in the *1991 National Real Estate Review*, as well as the information provided herein, is based on real estate market statistics for 50 Metropolitan Statistical Areas throughout the country provided to NAR by REIS Reports, Inc.

For information on how to obtain the *1991 National Real Estate Review* contact:

Investment Real Estate Research Department
National Association of Realtors®
777 14th Street, N.W.
Washington, D.C. 20005
202/383-1242

Ruth Sergenian
Director of Investment Real Estate Research
Economics & Research

U.S. Economic Outlook: October 1991

	91.1	91.2	91.3	91.4	92.1	92.2	92.3	92.4	1989	1990	1991	1992	1993
U.S. Economy													
Annual Growth Rate													
Real GNP	-2.8	-0.5	2.5	1.3	2.6	3.6	3.3	3.0	2.5	1.0	-0.5	2.5	3.0
Industrial Production	-9.6	2.4	7.1	1.7	3.0	5.7	6.3	5.9	2.6	1.0	-1.7	4.3	5.6
Civilian Employment	-2.4	0.3	-1.4	0.8	0.9	1.6	1.9	1.6	2.0	0.5	-1.0	0.9	1.6
GNP Inflation Index	5.2	4.5	3.0	3.2	3.2	2.5	2.6	2.6	4.1	4.1	4.0	3.0	2.8
Consumer Prices	3.5	2.1	2.8	3.4	3.3	3.1	3.3	3.6	4.8	5.4	4.2	3.2	3.5
Value of the U.S. Dollar	8.0	45.9	1.6	-0.9	-2.0	-2.6	-3.1	0.2	6.2	-9.6	2.2	0.9	0.2
Percent													
Mfg. Capacity Utilization	78.0	77.9	78.7	78.5	78.7	79.6	80.6	81.6	84.0	82.3	78.3	80.1	83.7
Civilian Unemployment	6.5	6.8	6.8	6.9	6.9	6.8	6.6	6.5	5.3	5.5	6.8	6.7	6.1
Percent of GNP													
Federal Tax Receipts	20.4	20.3	20.2	20.3	20.5	20.5	20.5	20.5	20.2	20.3	20.3	20.5	20.5
Federal Expenditures	22.7	23.6	23.8	24.3	24.6	24.5	24.2	24.0	22.8	23.3	23.6	24.3	23.7
Federal Budget Deficit	-2.3	-3.3	-3.6	-4.1	-4.1	-4.0	-3.7	-3.5	-2.6	-3.0	-3.3	-3.8	-3.2
Interest Rates, Percent													
Federal Funds Rate	6.4	5.9	5.7	5.2	5.2	5.3	5.5	5.5	9.2	8.1	5.8	5.4	5.9
3-Month T-Bill Rate	6.0	5.6	5.4	5.1	5.1	5.1	5.2	5.2	8.1	7.5	5.5	5.1	5.4
Prime Rate	9.2	8.7	8.4	8.0	8.0	8.1	8.3	8.3	10.9	10.0	8.6	8.2	8.4
Discount Rate	6.2	5.7	5.4	5.0	5.0	5.0	5.0	5.0	6.9	7.0	5.6	5.0	5.3
Corporate AAA Bond Yield	8.9	8.9	8.8	8.6	8.4	8.3	8.2	8.2	9.3	9.3	8.8	8.3	8.2
30-Year Government Bond Yield	8.2	8.3	8.2	7.9	7.8	7.7	7.7	7.7	8.4	8.6	8.2	7.7	7.7
Mortgage Rates, Percent													
30-Year Fixed Rate	9.5	9.5	9.3	8.8	8.7	8.6	8.5	8.4	10.3	10.1	9.3	8.5	8.4
1-Year Adjustable	8.1	7.6	7.1	6.9	6.8	6.7	6.7	6.7	9.3	8.4	7.1	6.7	6.5
Home Sales & Starts													
Thousands													
Total Single-Family Sales*	3,798	4,289	4,137	4,200	4,317	4,415	4,425	4,463	4,413	4,164	4,106	4,405	4,541
Existing Single-Family Sales	3,093	3,480	3,273	3,327	3,438	3,502	3,483	3,509	3,440	3,296	3,293	3,483	3,562
New Single-Family Sales	466	511	515	524	538	556	562	570	650	534	504	557	586
Housing Starts	915	998	1,060	1,089	1,119	1,176	1,216	1,238	1,376	1,193	1,016	1,187	1,302
Single-Family Units	726	834	890	901	907	941	972	983	1,003	895	838	951	1,009
Multi-Family Units	189	164	170	188	212	234	244	255	373	298	178	236	293
2-4 Family Units	31	31	31	33	37	39	40	40	55	38	32	39	43
5+ Family Units	158	134	139	155	176	195	204	215	318	260	146	197	251
Mobile Homes Shipped	161	174	206	217	225	235	242	242	199	188	189	236	243
Percent change -- Year Ago													
Total Single-Family Sales	-15.2	1.3	0.2	8.3	13.7	2.9	7.0	6.2	-4.4	-5.9	-1.7	7.3	3.1
Existing Single-Family Sales	-10.2	3.5	-0.7	6.7	11.1	0.6	6.4	5.5	-4.3	-4.2	-0.1	5.8	2.3
New Single-Family Sales	-22.0	-5.3	-1.5	11.5	15.5	8.8	9.0	8.9	-3.3	-17.8	-5.6	10.4	5.3
Housing Starts	-36.1	-17.1	-6.2	4.5	22.3	17.8	14.7	13.7	-7.5	-13.3	-14.9	16.9	9.7
Single-Family Units	-31.8	-7.0	3.9	14.5	24.9	12.9	9.2	9.2	-7.3	-10.8	-6.4	13.5	6.1
Multi-Family Units	-48.7	-46.6	-38.0	-26.4	12.0	42.6	43.5	35.5	-8.0	-20.1	-40.2	32.8	24.1
2-4 Family Units	-27.1	-29.2	-3.0	8.0	16.9	28.1	27.8	20.2	-5.8	-32.1	-15.7	23.2	9.3
5+ Family Units	-51.5	-49.5	-42.7	-31.1	11.1	45.9	47.1	38.8	-8.3	-18.0	-43.8	34.9	27.0
Median Home Prices													
Thousands of Dollars													
Existing Home Prices	95.9	101.1	102.5	102.9	103.4	104.6	105.8	107.4	93.1	95.5	100.6	105.3	110.0
New Home Prices	120.2	118.8	121.1	123.6	125.2	126.1	128.3	129.5	120.0	122.9	120.9	127.3	132.8
Percent Change - Year Ago													
Existing Home Prices	0.5	4.7	6.2	11.6	7.7	3.4	3.1	4.4	4.4	2.8	5.7	4.6	4.5
New Home Prices	-2.9	-6.2	3.8	1.3	4.1	6.1	5.9	4.8	5.9	2.4	-1.1	5.2	4.4

Quarterly figures are seasonally adjusted annual rates.

* Total single-family sales equals single-family resales plus 97% of single-family housing starts.

Source: Forecast produced using Laurence H. Meyer & Associates' model of the U.S. economy.
Assumptions and simulations by Dr. John Tuccillo, Robert Barr and Kimberly Martin.

The *Real Estate Outlook* features a monthly summary of the current condition of the U.S. economy, easy-to-read forecasts for the economy and real estate, and selected reports on issues affecting the housing industry. In addition, one of the nation's top real estate economists, Dr. John Tuccillo, gives his commentary on the state of the economy and its implications for real estate markets.

If you would like to subscribe to the *Real Estate Outlook*, contact the Forecasting and Policy Analysis Division at (202) 383-1131. The annual subscription fee is $25 for members of the NATIONAL ASSOCIATION OF REALTORS® and $30 for nonmembers.

Editorial questions can be directed to Robert Barr at (202) 383-7525.

REALTOR®

EQUAL HOUSING
OPPORTUNITY